1981–82 MISCELLANEOUS TAX BILLS IX

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 578, S. 768, S. 1276, S. 1472

SEPTEMBER 25, 1981

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

87-056 O WASHINGTON : 1981 HG 97-49

S361-7

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1981-82 MISCELLANEOUS TAX BILLS IX

SEPTEMBER 25, 1981

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2121, Dirksen Senate Office Building, Hon. Robert Packwood (chairman of the subcommittee) presiding.

Present: Senators Packwood, Durenberger, Long, and Moynihan.

[The committee press release, the bills S. 578, S. 768, S. 1276, and S. 1472 and Joint Committee on Taxation descriptions follow:]

PRESS RELEASE

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON FOUR MISCELLANEOUS TAX BILLS

Senator Packwood, Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, announced today that the Subcommittee will hold a hearing on September 25, 1981, on four miscellaneous tax bills.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

The following legislative proposals will be considered at the hearing:

S. 578—Introduced by Senator Moynihan. S. 578 would change certain accounting rules related to LIFO inventory accounting and allow companies to writedown inventory items in accordance with actual business experience.

S. 768—Introduced by Senator Moynihan. S. 768 would exclude certain research and development expenditures for purposes of the small issue exemption for industrial revenue bonds.

S. 1276—Introduced by Senator Durenberger. S. 1276 would allow certain small businesses to writedown the value of certain inventory items.

S. 1472—Introduced by Senator Denton. S. 1472 would exclude certain research and development expenditures for purposes of the small issue exemption for industrial revenue bonds.

Requests to testify.—Witnesses who desire to testify at the hearing must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than noon on Monday, September 21, 1981. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such a case, a witness should notify the Committee of his inability to appear as soon as possible.

Consolidated testimony.—Senator Packwood urges all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokeman to present their common viewpoint orally to the Subcommittee. This procedure will enable the Subcommittee to receive a wider expression of views than it might otherwise obtain. Senator Packwood urges that all witnesses exert a maximum effort to consolidate and coordinate their statements.

Legislative Reorganization Act.—Senator Packwood stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed

testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) All witnesses must submit written statements of their testimony.

(2) *Written statements must be typed on letter-size paper* (not legal size) and at least 100 copies must be delivered not later than noon on Thursday, September 24, 1981.

(3) *All witnesses must include with their written statements a summary of the principal points included in the statement.*

(4) *Witnesses should not read their written statements to the Subcommittee,* but ought instead to confine their oral presentations to a summary of the points included in the statement.

(5) Not more than five minutes will be allowed for the oral summary.

Written statements.—Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, not later than Friday, October 9, 1981. On the first page of your written statement please indicate the date and subject of the hearing.

DESCRIPTION OF TAX BILLS
(S. 578, S. 768, S. 1276, and S. 1472)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON SEPTEMBER 25, 1981

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on September 25, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are four bills scheduled for the hearing: S. 578 (relating to inventory writedowns and LIFO inventories); S. 768 and S. 1472 (relating to exclusion of research expenses from capital expenditure limitation on interest exemption for small issue industrial development bonds); and S. 1276 (relating to inventory writedowns).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation, and effective dates.

I. SUMMARY

1. S. 578 (Senators Moynihan, Melcher, Eagleton, East, Williams, Baucus, Inouye, and Sarbanes), and S. 1276 (Senators Durenberger, Melcher, Boschwitz, Zorinsky, and Grassley):

a. Section 1 of S. 578 and S. 1276—Inventory Writedowns

Present law

For income tax purposes, inventories are used as a method of determining the cost of goods sold and hence a taxpayer's gross income from the sale of goods. Under present law, a taxpayer may "write down" the value of its inventories (thereby decreasing gross income in the year of writedown) if the taxpayer uses the lower of cost or market method of inventory accounting or, in the case of "subnormal" goods, if the goods are actually sold below cost within a relatively short period after the inventory date (Reg. § 1.471–2(c)).

In 1979, the U.S. Supreme Court upheld the disallowance of inventory writedowns which failed to comply with these Treasury regulations, on the ground that such writedowns fail to clearly reflect income (*Thor Power Tool Co.* v. *Commissioner*). Subsequently, the Internal Revenue Service issued Revenue Procedure 80–5 and Revenue Ruling 80–60 to implement the *Thor Power* decision.

S. 578, Section 1

Section 1 of S. 578 would allow a taxpayer to write down portions of inventories to net realizable value based on a five-year average of items in that inventory that were disposed of at less than cost. This provision would apply to taxable years ending on or after December 25, 1979.

S. 1276

S. 1276 would allow a qualified small business to write off one-third of inventory held for more than 12 months, 50 percent of inventory held for more than 24 months, and 100 percent of inventory held for more than 36 months. This provision would apply to taxable years beginning after December 31, 1980. Also, S. 1276 would delay the effective date of Rev. Proc. 80–5 and Rev. Rul. 80–60 to taxable years beginning after December 31, 1980.

b. Sections 2 and 3 of S. 578—LIFO Inventories

Under present law, taxpayers that elect to use the LIFO method of accounting for inventories must use LIFO for purposes of their financial statements (sec. 472). Also, taxpayers electing LIFO must include in income inventory market writedowns taken for inventories that remain unsold. Under the Economic Recovery Tax Act of 1981, this income is to be taken into account ratably over the three-year period beginning with the taxable year of the LIFO election.

Section 2 of S. 578 would allow taxpayers to use LIFO accounting for tax purposes regardless of the method of inventory accounting used for purposes of financial statements. Section 3 of the bill would extend the three-year recapture of inventory writedowns to ten years. The provisions of sections 2 and 3 of the bill would be effective for taxable years beginning after the date of enactment of the bill.

2. S. 768—Senator Moynihan, and S. 1472—Senator Denton

Exclusion of Research Expenses From Capital Expenditure Limitation on Interest Exemption for Small Issue Industrial Development Bonds

Present law

Interest on certain State and local industrial development bonds is exempt from Federal income tax, pursuant to an exception under present law for "small issues," where the aggregate amount of outstanding exempt small issues plus capital expenditures (financed otherwise than out of small issue bond proceeds) does not exceed $10 million (Code sec. 103(b)(6)). Because research and experimentation expenditures are considered to be capital expenditures, such expenses are to be taken into account in determining whether the $10 million limitation is exceeded, whether or not the taxpayer elects to deduct currently or amortize research expenses under Code section 174 (Rev. Rul. 77-27, 1977-1 C.B. 23).

S. 768

Under the provisions of S. 768, research and experimental expenditures (within the meaning of sec. 174) would not be taken into account for purposes of the capital expenditure limitation on small issue industrial development bonds. The bill would apply to obligations issued after the date of enactment, and also to capital expenditures made after December 31, 1980.

S. 1472

Under the provisions of S. 1472, research or experimental expenditures which the taxpayer elects to deduct currently under section 174(a) would not be taken into account for purposes of the capital expenditure limitation on small issue industrial development bonds. The bill would apply to research or experimental expenditures paid or incurred after March 11, 1981, with respect to obligations issued after that date.

II. DESCRIPTION OF BILLS

1. S. 578—Senators Moynihan, Melcher, Eagleton, East, Williams, Baucus, Inouye, and Sarbanes, and S. 1276—Senators Durenberger, Melcher, Boschwitz, Zorinsky, and Grassley

a. Section 1 of S. 578 and S. 1276—Inventory Writedowns

Present law

Background

Gross income from the sale of goods equals gross sales receipts less the cost of goods sold. The computation of cost of goods sold is made by taking the beginning inventory, adding the purchases made during the year, and subtracting the ending inventory. The resulting amount is the amount of goods that were disposed of during the year and are presumed sold.

The dollar value of the ending inventory is determined by actually counting the goods on hand at the end of the year and then ascribing a value to those goods. The valuation method is important because a higher value will result in a lower cost of goods sold and thus greater taxable income, while a lower value will result in a higher cost of goods sold and thus lower taxable income. For example, a decrease or "writedown" in closing inventory increases the cost of goods sold for the year of writedown, and hence reduces gross income.

For Federal income tax purposes, Code section 471 requires a taxpayer to account for inventories in a manner that conforms as nearly as possible to the best accounting practice in the taxpayer's trade or business and most clearly reflects the taxpayer's income. Treasury regulations provide that the two most commonly used bases for valuing inventories which satisfy these requirements are (1) cost and (2) the lower of cost or market (Reg. § 1.471–2(c)).

A taxpayer using the latter method is permitted to write down the value of inventory items from the cost of the items to market value. (In general, the market value of merchandise is the bid price prevailing in the marketplace for the goods.) In addition, a taxpayer using the lower of cost or market method may write down inventories to below market value if, in the regular course of business, the taxpayer offers merchandise for sale at less than the prevailing market price. If actual sales are made at prices which do not materially vary from offering prices, the goods may be written down to the offering prices, less any direct costs of disposition.

Taxpayers using either the cost or lower of cost or market method of valuation may write down subnormal goods (goods which cannot be sold at normal prices because of damage, imperfections, shop wear, and similar infirmities) to a bona fide selling price, less direct costs of disposition. The bona fide selling price is defined as the selling price at which the goods are actually offered for sale during a period ending not later than 30 days after the inventory date (generally, the taxpayer's year-end).

"Thor Power" decision

In *Thor Power Tool Co.* v. *Commissioner*,[1] decided January 16, 1979, the U.S. Supreme Court affirmed decisions of the Seventh Circuit and Tax Court upholding the disallowance of "excess inventory" writedowns which failed to satisfy the requirements under the section 471 regulations for writedowns of inventory below cost. The Court stated that the Congress has given the Internal Revenue Service broad discretion, under Code sections 446 and 471, to determine whether a particular method of inventory accounting clearly reflects the taxpayer's income. Citing the "well-known potential for tax avoidance that is inherent in inventory accounting," the Supreme Court stated that to permit writedowns without objective evidence of the inventory's value (e.g., actual sales prices during the year) would allow a taxpayer "to determine how much tax it wanted to pay for a given year."

The taxpayer in *Thor Power* manufactured hand-held power tools that contained from 50 to 200 parts. The company had a policy of manufacturing all estimated future replacement parts at the same time it manufactured a new product. In this way, the company sought to avoid the problem of having to retool at some future date in order to provide replacement parts to its customers. Therefore, the company had more replacement parts on hand than it would need in the immediate future.

In 1964, Thor Power's new management determined that a large portion of the parts inventory was in excess of any reasonably foreseeable future demand. Therefore, the company wrote the inventory down to scrap value for both financial statement purposes and tax purposes. The taxpayer did not attempt to sell these goods at reduced prices or to scrap them; instead, the parts were retained for possible future sales to customers at their original list price.

On audit, the Internal Revenue Service agreed that the company's method of accounting for its inventory was in conformity with the best accounting practice in its trade or business, because it was standard accounting policy to write down excess inventories to their net realizable value. However, the Revenue Service determined that the writedown did not clearly reflect the taxpayer's income. The Revenue Service contended that in order to clearly reflect income for tax purposes, the writedown had to conform to the requirements of the section 471 regulations regarding market writedowns, and that the taxpayer's writedown did not conform to those requirements.

The company's writedown of "excess inventory" reflected not a reduction in the market value of the individual replacement parts, but a judgment that less than all the parts would be sold. Also, the writedown did not reflect an offer to sell the replacement parts at less than market value or actual sales of subnormal goods. The "excess" inventories were physically indistinguishable from normal goods, and the company stated that it continued to sell the parts at their original list prices. The writedown, therefore, did not meet the requirements of the regulations, which provided only for writedowns to market value, writedowns to offering price below market value (less direct costs of disposition) and writedowns to bonafide selling price (less direct costs of disposition) for subnormal goods.

[1] 439 U.S. 522 (1979).

Upholding the Revenue Service's determination that the writedown did not clearly reflect income, as required by the regulations, the Supreme Court also rejected the taxpayer's argument that conformity to generally accepted accounting principles gave rise to a presumption of clear reflection of income. Because income tax rules have different objectives than accounting rules, the Court stated, tax issues are not controlled by accounting practices; the Court also observed that divergence between accounting and tax treatment is particularly great where a taxpayer seeks a current deduction for estimated future expenses or losses.

Revenue Procedure 80–5 and Revenue Ruling 80–60

On February 8, 1980, the Internal Revenue Service issued a news release (IR–80–19, I.R.B. 1980–6) announcing the publication of Revenue Procedure 80–5 and Revenue Ruling 80–60. Both pronouncements dealt with the Supreme Court's 1979 decision in *Thor Power* and the writedown of excess inventories. The pronouncements required full implementation of the *Thor Power* decision for taxpayers with 1979 calendar year-ends.

Under Code section 446, a taxpayer may not change the method under which it accounts for income unless it secures the consent of the Revenue Service. This procedure can have the result of requiring a taxpayer to continue to use an erroneous accounting method unless it secures consent to change.

With respect to the *Thor Power* decision, the Internal Revenue Service believed that many taxpayers would not request permission to change to the proper method of accounting for excess inventories and, under the requirement that they maintain their method of accounting, would continue improperly to write down excess inventories. This not only would give taxpayers the advantage of continuing to write off excess inventories until eventually challenged on audit, but it held out the prospect that the erroneous method of inventory accounting might never be discovered by the Revenue Service.

As a response to the possibility that taxpayers would not request permission to change erroneous methods of inventory accounting in accordance with the *Thor Power* decision, the Revenue Service issued Revenue Procedure 80–5 and Revenue Ruling 80–60 on February 8, 1980. Rev. Proc. 80–5 [2] granted blanket permission to all taxpayers to change their method of inventory accounting to conform with the *Thor Power* decision. Rev. Rul. 80–60,[3] which presented a fact situation regarding excess inventories, stated in its conclusion that if a taxpayer did not account for inventory in accordance with the *Thor Power* decision and Revenue Procedure 80–5, the taxpayer would be filing its tax return "not in accordance with the law." The implication of this last statement was that the taxpayer would be liable for various penalties for failure to file a proper tax return.

It is the position of many taxpayers that the retroactive application of the two Revenue Service pronouncements (issued in 1980 but to take effect in 1979) precludes them from being able to comply in 1979 with certain Treasury regulations that would have mitigated the income recapture required under the *Thor Power* decision. Under the

[2] 1980–1 C.B. 582.
[3] 1980–1 C.B. 446.

regulations, normal goods may be written down to below market value if the goods are offered for sale at below market prices in the taxable year the writedown is to be taken. The taxpayers claim that if they had had proper notice of the pronouncements in 1979, they would have offered a large part of their excess inventory for sale at reduced prices in 1979. Thus, they would have been in compliance with both the Treasury regulations and the *Thor Power* decision on such inventory writedowns and would not have had to recapture income with respect to that inventory.

Issues

The principal issue is whether taxpayers should be able to write down the value of excess inventories that continue to be sold at prices in excess of cost. A secondary issue is whether the application of Rev. Rul. 80–60 and Rev. Proc. 80–5 should be delayed from 1979 to 1981.

Explanation of provisions

S. 578, Section 1

S. 578 would allow taxpayers to value excess inventory at net realizable value. The bill would define excess inventory as that portion of the taxpayer's ending inventory which the taxpayer reasonably expects will be disposed of at less than full realization of its cost.

The amount of the excess inventory would be based on the taxpayer's five-year experience with each group of articles contained in the inventory. Thus, the taxpayer would look to each group of articles contained in its inventory and determine the average percentage of its inventory that was disposed of at less than cost for the past five years. The taxpayer would then apply that average percentage to the current amount in the ending inventory for that group; the resulting amount would be the taxpayer's excess inventory for that group. That amount of excess inventory would then be written down to its net realizable value.

S. 1276

S. 1276 would provide an election for qualified small businesses to write down, over a four-year period, inventory items which have been held by the taxpayer for more than 12 months.

Under the election, inventory items that have been held for more than one year but not more than two years could be written down by not more than one-third of their inventory value as of the time of the writedown. Items held for more than two years but not more than three years could be written down by not more than half their inventory value as of the time of the writedown. Inventory items held more than three years could be written down by not more than the full inventory value of the item as of the time of the writedown.

A qualified small business would be defined as a domestic trade or business with equity capital of $25 million or less. Special rules would be provided to treat commonly controlled trades or businesses as a single trade or business for purposes of determining whether the members of the group are qualified small businesses.

The bill also would delay the effective date of Rev. Proc. 80–5 and Rev. Rul. 80–60 from taxable years endiing after December 24, 1979, to taxable years beginning after December 31, 1980. A taxpayer which changed its method of accounting for a taxable year ending after

December 24, 1979 and before January 1, 1981, in accordance with Rev. Rul. 80–60 and Rev. Proc. 80–5, would be able to change the method of accounting for any such taxable year back to the method of accounting that had been previously used. This change could be made without the consent of the Revenue Service by filing an amended tax return.

Effective date

S. 578, Section 1

This provision of S. 578 would apply to taxable years ending on or after December 25, 1979 (the date on which Rev. Proc. 80–5 and Rev. Rul. 80–60 became effective to implement the *Thor Power* decision).

S. 1276

The amendments made by S. 1276 relating to inventory writedowns for qualified small businesses would apply to taxable years beginning after December 31, 1980. The provisions relating to Rev. Rul. 80–60 and Rev. Proc. 80–5 would apply to taxable years ending after December 24, 1979 and beginning before January 1, 1981.

b. Sections 2 and 3 of S. 578—LIFO Inventories

Present law

Background

Gross income from the sale of goods equals gross sales receipts less the cost of goods sold. The computation of cost of goods sold is made by taking the beginning inventory, adding the purchases made during the year, and subtracting the ending inventory. The resulting amount is the amount of goods that were disposed of during the year and are presumed sold.

The dollar value of the ending inventory is determined by actually counting the goods on hand at the end of the year and then ascribing a value to those goods. The valuation method is important because a higher value will result in a lower cost of goods sold and thus greater taxable income, while a lower value will result in a higher cost of goods sold and thus lower taxable income.

There are several methods for valuing ending inventories. The first-in, first-out ("FIFO") method presumes that the earliest acquired goods are sold first and that the ending inventory consists of the most recent purchases. The last-in, first-out ("LIFO") method presumes that the goods most recently purchased are sold first and that the ending inventory consists of the earliest acquired goods. Other principal methods are the average cost method, under which the costs of all goods owned during the year are averaged, and the specific identification method, under which the individual price of each item in inventory is determined.

LIFO

In 1938, the Congress allowed the use of LIFO by taxpayers in a few specified industries, and in 1939, by all taxpayers. However, it was unclear at that time whether the accounting profession accepted LIFO as clearly reflecting income for purposes of financial statements. Since clear reflection of income has always been the primary standard for approved methods of accounting, the use of LIFO for tax purposes was conditioned on the requirement (the "conformity requirement") that the taxpayer use LIFO in preparing its financial statements (sec. 472). At present, LIFO is an accepted method of accounting for inventories for financial statement purposes.

Since the use of LIFO in times of rising inflation results in lower taxable income than would be the case with FIFO, these comparatively lower earnings are also reflected in the taxpayer's published financial statements because of the conformity requirement. Inasmuch as the operating success of a business is measured in large part by its earnings, many taxpayers using LIFO feel at a competitive disadvantage with similarly situated taxpayers which do not use LIFO and thus report higher earnings on essentially the same income. Many of these businesses have not changed to LIFO because of this effect of the conformity requirement.

Two recent developments have ameliorated the adverse financial statement impact of the conformity requirement. First, final Treasury regulations have been issued that allow taxpayers using LIFO to disclose in their financial statements the amount of earnings they would have had on a non-LIFO basis. However, although the regulations allow the taxpayer to prepare a supplemental income statement on a non-LIFO basis, the taxpayer must prepare its primary financial statements using LIFO (Reg. § 1.472–2(e)).

The second event was the decision of the Second Circuit in *Insilco Corporation* v. *Commissioner* (unpublished opinion dated April 17, 1981), affirming a decision of the U.S. Tax Court that the conformity requirement applicable to a subsidiary using LIFO does not extend to the subsidiary's parent company which is not using LIFO. Thus, the parent company can incorporate the non-LIFO financial statements of the subsidiary in its consolidated financial statement.

Another requirement of the LIFO method is that the inventory must be accounted for only at cost, while under FIFO, the taxpayer can elect to value inventory at the lower of cost or market. Thus, when the value of an item of inventory declines below cost, a taxpayer using FIFO may write off the decline in value ("market writedowns") and carry the inventory at its new lower value. Under LIFO, the taxpayer may not take such a writedown. Moreover, if the ending inventory of the year immediately preceding the year of change to LIFO contains any items that have had market writedowns, the taxpayer must write the inventory back up to cost and include the entire write-up in income in such preceding year. Thus, in the year of change to LIFO all items of beginning inventory will be carried at cost.

In the Economic Recovery Tax Act of 1981 (P.L. 97–34), the Congress amended the rules relating to the recapture of market writedowns (sec 472(d)). For taxpayers adopting LIFO for taxable years beginning after December 31, 1981, market writedowns will be included in income ratably over a three-year period beginning with the year of change to LIFO. Thus, the taxpayer no longer will have to amend the return of the year preceding the year of the LIFO election and include the entire amount of market writedowns in income in that year.

Issues

The issues are whether to eliminate the LIFO conformity requirement, and whether to allow taxpayers to spread the recapture of inventory writedowns over a ten-year period.

Explanation of provisions

Section 2 of the bill would eliminate the conformity requirement, so that taxpayers could use LIFO for tax purposes regardless of the method used for financial statement purposes. Section 3 of the bill would allow taxpayers to spread the recapture of inventory writedowns equally over ten years, beginning with the year of change, rather than spreading it over three years as was recently provided in the Economic Recovery Tax Act of 1981 (P.L. 97–34).

Effective date

The provisions of sections 2 and 3 of S. 578 would be effective for taxable years beginning after the date of enactment of the bill.

2. S. 768—Senator Moynihan, and S. 1472—Senator Denton

Exclusion of Research Expenses from Capital Expenditure Limitation on Interest Exemption for Small Issue Industrial Development Bonds

Present law

In general

Interest on State and local government obligations generally is exempt from Federal income tax (Code sec. 103(a)). However, subject to certain exceptions, interest on State and local issues of industrial development bonds is taxable (sec. 103(b)). An obligation constitutes an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a governmental unit or tax-exempt organization and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business (sec. 103(b)(2)).

Present law provides an exception for certain "small issues" to the general rule of taxability of interest paid on industrial development bonds (sec. 103(b)(6)). This exception applies to issues of $1 million or less if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property.

At the election of the issuer, the $1 million limitation may be increased to $10 million. If this election is made, the exception is restricted to projects where the aggregate amount of outstanding exempt small issues and capital expenditures (financed otherwise than out of the proceeds of an exempt small issue) made over a six-year period [1] does not exceed $10 million. The combined issue amount/capital expenditure limitation of $10 million has the effect of precluding availability of an interest exemption where industrial development bonds would have a face amount not exceeding the $10 million dollar limitation but would be used in connection with large scale, high cost projects.

Both the $1 million and $10 million limitations are determined by aggregating the face amount of all outstanding related issues, plus, in the case of the $10 million limitation, certain capital expenditures for all facilities used by the same or related principal users which are located within the same county or same incorporated municipality. Under Treasury regulations, expenditures are treated as capital expenditures for this purpose if they are properly chargeable to the capital account of any person or State or local governmental unit. This determination is to be made without regard to any rule of the Internal Revenue Code that permits expenditures properly chargeable to capital account to be tretaed as current expenses (Reg. § 1.103–10(b)(2)(ii)(e)).

[1] The relevant six-year period is the period beginning three years before the date of the issue and ending three years after that date.

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Treatment of research expenditures

As a general rule, business expenditures to develop or create an asset which has a useful life that extends substantially beyond the taxable year must be capitalized and cannot be deducted in the year paid or incurred. For example, research expenditures to develop a new consumer product must be capitalized, because such expenditures relate to an asset which will have a useful life exceeding one year. Such capital costs usually may be recovered on a disposition or abandonment of the asset, or through depreciation or amortization deductions over the useful life of the asset.

However, present law permits a taxpayer to elect to deduct currently the amount of research or experimental expenditures incurred in connection with the taxpayer's trade or business, even if such expenses are treated as capital account charges or deferred expenses on the taxpayer's books or financial statements (sec. 174(a); Rev. Rul. 58–78, 1958–1 C.B. 148). In the case of research expenditures resulting in property which does not have a determinable useful life (such as secret processes or formulae), the taxpayer alternatively may elect to deduct the costs ratably over a period of not less than 60 months (sec. 174(b)).[3]

Because research and experimentation expenditures constitute capital expenditures, such expenses are to be taken into account for purposes of determining whether the exempt small issue limitation of $10 million is exceeded, whether or not the taxpayer elects to deduct its research expenses currently or to amortize them over a period of 60 months or more (Rev. Rul. 77–27, 1977–1 C.B. 23).

In addition to the favorable deduction treatment provided under Code section 174 for research expenditures, the Economic Recovery Tax Act of 1981 provides a 25-percent tax credit for certain research and experimental expenditures paid in carrying on a trade or business of the taxpayer to the extent exceeding the amount of such expenditures during a base period (Code sec. 44F).

Issue

The issue is whether research and experimental expenditures should be counted toward the $10 million limitation for exemption of interest on "small issue" industrial development bonds.

Explanation of bills and effective dates

S. 768

Under S. 768, research and experimental expenditures (within the meaning of sec. 174) would not be taken into account for purposes of the capital expenditure limitation on small issue industrial development bonds. The bill does not expressly restrict such treatment to research expenditures which the taxpayer elects under section 174 to deduct currently or amortize.

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[3] If expenditures relating to development of a product are not eligible for these elections, or if the taxpayer chooses not to elect either current deductions or amortization for qualifying research costs, such expenditures must be capitalized. If the capitalized expenses relate to depreciable property, deductions may be taken in the form of depreciation allowances spread over the property's useful life. If the capitalized expenses relate to nondepreciable property, those costs cannot be recovered until disposition or abandonment of the property.

S. 768 would apply to obligations issued after the date of enactment, in taxable years ending after that date. Also, the bill would apply to capital expenditures made after December 31, 1980, for purposes of applying the $10 million limitation in the case of obligations issued prior to the enactment date.

S. 1472

Under S. 1472, research or experimental expenditures which the taxpayer elects to deduct currently under section 174(a) would not be taken into account for purposes of the capital expenditure limitation on small issue industrial development bonds.

S. 1472 would apply to research or experimental expenditures paid or incurred after March 11, 1981, with respect to obligations issued after that date.

97TH CONGRESS
1ST SESSION

S. 578

To amend the Internal Revenue Code to change certain accounting rules related to inventory.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 26 (legislative day, FEBRUARY 16), 1981

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code to change certain accounting rules related to inventory.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. EXCESS INVENTORY ITEMS MAY BE WRITTEN DOWN TO SCRAP VALUE.

Section 471 of the Internal Revenue Code of 1954 (relating to the general rule for inventories) is amended by adding at the end thereof the following new sentences: "A taxpayer may value his excess inventory at its net realizable value. For purposes of this section, the term 'excess inven-

tory' means that portion of the taxpayer's inventory which the taxpayer reasonably expects will be disposed of at less than full realization of its cost. Such portion shall be determined with respect to each group of articles by age by referring to the taxpayer's most recent 5-year experience with inventories.".

SEC. 2. REPEAL OF REQUIREMENT THAT THE LIFO METHOD USED FOR TAX PURPOSES CONFORM TO THE ACCOUNTING METHOD USED FOR FINANCIAL PURPOSES.

Section 472 of such Code (relating to last-in, first-out inventories) is amended by striking out subsections (c) and (e) and by redesignating subsection (d) as subsection (c).

SEC. 3. 10-YEAR SPREAD PERMITTED FOR INCREASES IN INVENTORY VALUE REQUIRED FOR ADOPTION OF LIFO METHOD.

Subsection (b) of section 472 of such code (relating to last-in, first-out inventories) is amended by adding at the end thereof the following new sentence: "for purposes of section 481, any increase in the valuation of inventory required by paragraph (2) shall be treated as an adjustment attributable to a change in a method of accounting initiated by the taxpayer.".

SEC. 4. EFFECTIVE DATES.

(a) The amendment made by section 1 of this Act shall apply to taxable years ending on or after December 25, 1979.

(b) The amendments made by sections 2 and 3 of this Act shall apply to taxable years beginning after the date of enactment.

97TH CONGRESS
1ST SESSION

S. 768

To amend the Internal Revenue Code to provide that certain research and development expenditures will not be taken into account for purposes of the small-issue exemption from the industrial development bond rules.

IN THE SENATE OF THE UNITED STATES

MARCH 23 (legislative day, FEBRUARY 16), 1981

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code to provide that certain research and development expenditures will not be taken into account for purposes of the small-issue exemption from the industrial development bond rules.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (6) of section 103(b) of the Internal Revenue Code of 1954 (relating to exemption for certain small issues) is amended by adding at the end thereof the following new subparagraph:

"(J) RESEARCH AND EXPERIMENTAL EXPENDITURES NOT TAKEN INTO ACCOUNT.—For purposes of applying subparagraph (D)(ii), research and experimental expenditures (within the meaning of section 174) shall not be taken into account.".

(b) The amendment made by subsection (a) shall apply—

(1) to obligations issued after the date of the enactment of this Act in taxable years ending after such date, and

(2) with respect to capital expenditures made after December 31, 1980.

97TH CONGRESS
1ST SESSION

S. 1276

To amend the Internal Revenue Code of 1954 to permit small businesses to reduce the value of excess inventory.

IN THE SENATE OF THE UNITED STATES

MAY 21 (legislative day, APRIL 27), 1981

Mr. DURENBERGER (for himself, Mr. MELCHER, Mr. BOSCHWITZ, Mr. ZORINSKY, and Mr. GRASSLEY) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to permit small businesses to reduce the value of excess inventory.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subpart D of part II of subchapter E of chapter 1 of the Internal Revenue Code of 1954 (relating to inventories) is amended by adding at the end thereof the following new section:

"SEC. 474. LIMITED REDUCTION IN VALUE OF EXCESS INVENTORIES OF SMALL BUSINESSES.

"(a) GENERAL RULE.—Except as provided in subsection (b), a qualificd small business may elect to treat any excess inventory item in the same manner as an inventory item which has been physically scrapped.

"(b) LIMITATION ON REDUCTION IN VALUE OF INVENTORY.—The amount of the reduction under subsection (a) of the inventory value of any inventory item shall not exceed—

"(1) 33⅓ percent of such inventory value as of the close of the taxable year if such item has been held more than 12 months but not in excess of 24 months,

"(2) 50 percent of such inventory value as of such date if such item has been held more than 24 months but not in excess of 36 months, and

"(3) such inventory value as of such date if such item has been held more than 36 months.

"(c) DEFINITIONS AND SPECIAL RULE.—For purposes of this section—

"(1) EXCESS INVENTORY.—The term 'excess inventory' means any inventory item which has been held by the taxpayer for more than 12 months.

"(2) QUALIFIED SMALL BUSINESS.—

"(A) IN GENERAL.—The term 'qualified small business' means any domestic trade or busi-

ness (whether or not incorporated) the equity capital of which does not exceed $25,000,000.

"(B) CONTROLLED GROUPS.—For purposes of determining under subparagraph (A) the equity capital of—

"(i) a member of the same controlled group of corporations (within the meaning of section 1563(a), except that 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in section 1563(a)(1)), and

"(ii) a member of a group of trades or businesses (whether or not incorporated) which are under common control, as determined under regulations prescribed by the Secretary which are based on principles similar to the principles which apply under clause (i),

the equity capital of all members of such group shall be taken into account.

"(C) EQUITY CAPITAL.—For purposes of this paragraph—

"(i) CORPORATION.—In the case of a corporation, the term 'equity capital' means the sum of its money and other property (in

an amount equal to the adjusted basis of such property for determining gain), less the amount of indebtedness (other than indebtedness to shareholders).

"(ii) NONCORPORATE BUSINESS.—In the case of a trade or business which is not organized as a corporation, equity capital shall be determined under regulations prescribed by the Secretary which are based on principles similar to the principles which apply under clause (i).

"(3) ELECTION.—An election under this section—

"(A) shall be in such form and manner as the Secretary may prescribe,

"(B) shall take effect at the beginning of the taxable year for which a return is filed notifying the Secretary of such election, and

"(C) may not be revoked without the consent of the Secretary.".

(b) CONFORMING AMENDMENT.—The table of sections for subpart D of part II of subchapter E of chapter 1 of such Code is amended by adding at the end thereof the following new item:

"Sec. 474. Limited reduction in value of excess inventories of small businesses.".

SEC. 2. EFFECTIVE DATE.

(a) IN GENERAL.—The amendments made by this section shall apply to taxable years beginning after December 31, 1980.

(b) APPLICATION OF REVENUE RULING 80–60.—

(1) IN GENERAL.—If a taxpayer would (but for this paragraph) be required under Revenue Ruling 80–60 and Revenue Procedure 80–5 to change his method of accounting for his first taxable year ending after December 24, 1979, such taxpayer shall be required to make such change only for taxable years beginning after December 31, 1980.

(2) CONSENT OF SECRETARY FOR ACCOUNTING CHANGE.—The consent granted by section 3.01 of Revenue Procedure 80–5 shall also apply to a taxpayer's first taxable year beginning after December 31, 1980.

(3) EXCEPTION FOR TAXPAYERS UNDER AUDIT.—This section shall not apply to a taxpayer to whom Revenue Procedure 80–5 does not apply by reason of section 3.06 thereof.

(4) TAXABLE YEARS BEGINNING BEFORE 1981.—In the case of a taxpayer who changed his method of accounting for any taxable year ending after

December 24, 1979, and before January 1, 1981, in accordance with Revenue Ruling 80–60 and Revenue Procedure 80–5, such taxpayer may change, without the consent of the Secretary of the Treasury, such method of accounting for any such taxable year to the method used for the taxable year immediately preceding the first taxable year ending after December 24, 1979 by filing an amended return of tax for any such taxable year within the time prescribed for filing such amended return.

II

97TH CONGRESS
1ST SESSION

S. 1472

To amend the Internal Revenue Code of 1954 to exclude the value of certain research and experimental expenditures from the aggregate face amount of certain small issues of industrial development bonds.

IN THE SENATE OF THE UNITED STATES

JULY 14 (legislative day, JULY 8), 1981

Mr. DENTON introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to exclude the value of certain research and experimental expenditures from the aggregate face amount of certain small issues of industrial development bonds.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (6) of section 103(b) of the Internal Revenue Code of 1954 (relating to exemption for certain small issues) is amended by adding at the end thereof the following new subparagraph:

"(K) RESEARCH OR EXPERIMENTAL EXPENDITURES NOT TAKEN INTO ACCOUNT.—For purposes of applying subparagraph (D)(ii), research or experimental expenditures which are treated as expenses not chargeable to capital account under section 174(a) shall not be taken into account in determining the aggregate face amount of an issue.".

(b) The amendment made by subsection (a) shall apply to research or experimental expenditures paid or incurred after March 11, 1981, with respect to obligations issued after such date.

Senator PACKWOOD. The subcommittee will please come to order.

We have four bills before us today, although two of them are twins, S. 768 and S. 1472, S. 578 and S. 1276.

I would ask the witnesses to abbreviate their testimony as much as possible.

All of your statements will be put in the record. We are going to start voting in the Senate at about 10:30, and I would like to finish and let everybody on if possible by that time, so we will start first this morning with the Honorable Jeremiah Denton, the Senator from Alabama.

Good morning, Jerry.

STATEMENT OF HON. JEREMIAH DENTON, SENATOR FROM THE STATE OF ALABAMA

Senator DENTON. Good morning, Bob.

I appreciate your consideration and courtesy in permitting me to go first, and I appreciate also Secretary Chapoton's patience and understanding in this regard.

I would not have asked for this, but I do have an AWACS meeting at almost exactly the same time.

I will abbreviate the statement and stay within about 6 minutes.

Before I begin, I want to emphasize that in general this proposal should help lead to the catalyzation of many approaches to one major thrust of the administration program, namely the expansion of business, the takeoff as it were, which was expected from the anticipations of the soundness of the implementation of President Reagan's program, which is to begin on October 1. That has not taken off yet. Wall Street has not shown it. The bond market has not shown it, and this is a part of that matter.

Mr. Chairman, members of the committee, I am pleased to be before you today to testify in favor of S. 1472, a bill I have introduced to encourage research and development by companies receiving tax-exempt financing under industrial development bonds.

I am accompanied by Mr. Stuart E. Eizenstat, a name quite familiar here in Washington, now an attorney for the Intergraph Corp. of Huntsville, Ala. Stuart first brought this situation to my attention.

Mr. Chairman, no factor is more important to improving the productivity of American industry and increasing our ability to compete successfully with foreign companies than adequate levels of research and development by the private sector.

Yet the Internal Revenue Code needlessly discourages R. & D. by companies receiving industrial development bond financing and thereby denying the most innovative companies access to the favorable financing terms made available by IDB's. S. 1472 would correct this problem.

As you know, section 103(B)(6) of the Internal Revenue Code permits a company to receive financing through "small issues" of tax-exempt industrial development bonds, as long as the company does not have more than $10 million in capital expenditures within the bond issuing jurisdiction in the 6-year period beginning 3 years prior to the issue date.

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The Internal Revenue Service has determined in private rulings that expenses for research are "capital expenditures" within the meaning of this section.

This contrasts with the normal tax treatment of R. & D. costs which, pursuant to section 174 of the Code, may be expensed rather than capitalized.

This IRS determination has had unfortunate consequences for research by American industry. Those companies which build, renovate or expand their facilities through the use of IDB's must avoid or curtail their research expenditures for a 6-year period in order to stay within the $10 million limit.

Even more seriously, the small, high-technology firms that have taken the lead with respect to innovation and productivity are effectively denied the advantages of tax exempt financing.

Please note that if a firm spends a large share of its budget on research and development, it cannot afford to finance its capital facilities—land, plant and equipment—through an industrial development bond.

In summary, companies that do little or no R. & D. actually are treated more favorably under the IDB rules.

My bill offers a simple solution to these problems.

It provides that research and experimental costs which are treated as expenses for the purposes of section 174 shall also be expenses for the purposes of the small- issue exemption under section 103(B)(6). By doing so, the bill provides uniform treatment for research and development expenses in the Code and avoids the uncertainty and unnecessary accounting problems created by the present IRS position.

The bill's revenue impact will be negligible, since the number and size of IDB issues should not increase significantly.

I understand that the administration does not oppose enactment of this bill. Mr. Eizenstat advises me that he has discussed this issue directly with Assistant Secretary of the Treasury for Tax Policy, John Chapoton, who assured him that Treasury would not object to the provision.

In conclusion, I want to point out one technical change that should be made in the bill as introduced. The bill was initially drafted with an effective date that would coincide with the proposed effective date of the business provisions of President Reagan's tax cut bill. Since that bill has been enacted, I would now recommend that S. 1472 be made applicable to all expenditures for reseach and experimentation after the date of its enactment.

To assure an immediate beneficial impact, the bill should apply to research and development expenditures by companies already operating under IDB's, as well as to expenditures under new bond issues. This would not validate bond issues that have already been ruled taxable or expenditures that have already been made. But it would remove the disincentive to research and development activities by companies using IDB's as of its effective date.

I request permission to submit for the record a proposed amendment to S. 1472 which would accomplish this.

Mr. Chairman, I appreciate your courtesy in allowing me to testify this morning, and I urge you to give prompt favorable consideration to S. 1472.

I thank you, sir.

Senator PACKWOOD. Jerry, I support the bill. I noticed in the President's speech last night, there was some reference to revenue bonds generally.

Senator DENTON. Yes.

Senator PACKWOOD. Perhaps Mr. Chapoton may want to address himself to that. He may support this provision, and we may have no revenue bills at all to which we attach this provision.

I have no questions. Thank you very much.

Senator DENTON. Thank you.

[The prepared statement of Senator Denton follows:]

TESTIMONY OF
SENATOR JEREMIAH DENTON
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
SEPTEMBER 25, 1981

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, I AM PLEASED TO APPEAR BEFORE YOU TODAY TO TESTIFY IN FAVOR OF S. 1472, A BILL I HAVE INTRODUCED TO ENCOURAGE RESEARCH AND DEVELOPMENT BY COMPANIES RECEIVING TAX-EXEMPT FINANCING UNDER INDUSTRIAL DEVELOPMENT BONDS. I AM ACCOMPANIED BY STUART E. EIZENSTAT, ATTORNEY FOR THE INTERGRAPH CORPORATION OF HUNTSVILLE, ALABAMA, WHICH FIRST BROUGHT THIS SITUATION TO MY ATTENTION.

MR. CHAIRMAN, NO FACTOR IS MORE IMPORTANT TO IMPROVING THE PRODUCTIVITY OF AMERICAN INDUSTRY AND INCREASING OUR ABILITY TO COMPETE SUCCESSFULLY WITH FOREIGN COMPANIES THAN ADEQUATE LEVELS OF RESEARCH AND DEVELOPMENT BY THE PRIVATE SECTOR. YET THE INTERNAL REVENUE CODE NEEDLESSLY DISCOURAGES R&D BY COMPANIES RECEIVING INDUSTRIAL DEVELOPMENT BOND FINANCING AND THEREBY DENIES THE MOST INNOVATIVE COMPANIES ACCESS TO THE FAVORABLE FINANCING TERMS MADE AVAILABLE BY IDBS. S.1472 WOULD CORRECT THIS PROBLEM.

AS YOU KNOW, SECTION 103(B)(6) OF THE INTERNAL REVENUE CODE PERMITS A COMPANY TO RECEIVE FINANCING THROUGH "SMALL ISSUES" OF TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS, AS LONG AS THE COMPANY DOES NOT HAVE MORE THAN $10 MILLION IN CAPITAL EXPENDITURES WITHIN THE BOND-ISSUING JURISDICTION IN THE SIX YEAR PERIOD BEGINNING THREE YEARS PRIOR TO THE ISSUE DATE. I WOULD STRESS THAT THIS $10 MILLION CAP APPLIES TO ALL OF A COMPANY'S CAPITAL EXPENDITURES IN THAT 6 YEAR PERIOD, NOT ONLY THOSE ACTUALLY FINANCED BY THE IDB.

THE INTERNAL REVENUE SERVICE HAS DETERMINED IN PRIVATE RULINGS THAT EXPENSES FOR RESEARCH ARE "CAPITAL EXPENDITURES" WITHIN THE MEANING OF THIS PROVISION. THIS CONTRASTS WITH THE NORMAL TAX TREATMENT OF R&D COSTS WHICH, PURSUANT TO SECTION 174 OF THE CODE, MAY BE EXPENSED RATHER THAN CAPITALIZED. IN OTHER WORDS, BECAUSE OF SECTION 174, RESEARCH AND DEVELOPMENT COSTS ARE GENERALLY PERMITTED TO BE TREATED AS EXPENSES. BECAUSE OF THE IRS RULINGS, HOWEVER, R&D COSTS IN THE IDB CONTEXT MUST BE TREATED AS CAPITAL EXPENDITURES, EVEN IF THEY ARE TREATED AS EXPENSES FOR ALL OTHER PURPOSES.

THIS IRS DETERMINATION HAS HAD UNFORTUNATE CONSEQUENCES FOR RESEARCH BY AMERICAN INDUSTRY. THOSE COMPANIES WHICH BUILD, RENOVATE OR EXPAND THEIR FACILITIES THROUGH THE USE OF IDBS MUST AVOID OR CURTAIL THEIR RESEARCH EXPENDITURES FOR A SIX YEAR PERIOD IN ORDER TO STAY WITHIN THE $10 MILLION LIMIT. EVEN MORE SERIOUSLY, THE SMALL, HIGH TECHNOLOGY FIRMS THAT ARE ON THE CUTTING EDGE OF THIS NATION'S INNOVATION AND PRODUCTIVITY, ARE EFFECTIVELY DENIED THE ADVANTAGES OF TAX-EXEMPT FINANCING. FOR IF A FIRM SPENDS A LARGE SHARE OF ITS BUDGET ON RESEARCH AND DEVELOPMENT, IT CANNOT AFFORD TO FINANCE ITS CAPITAL FACILITIES -- LAND, PLANT, AND EQUIPMENT -- THROUGH AN INDUSTRIAL DEVELOPMENT BOND.

IN SUMMARY, COMPANIES WHICH DO LITTLE OR NO R&D ACTUALLY ARE TREATED MORE FAVORABLY UNDER THE IDB RULES.

THE SITUATION OF MY CONSTITUENT, THE INTERGRAPH CORPORATION, ILLUSTRATES THE DETRIMENTAL EFFECT OF THIS RULE.

INTERGRAPH MANUFACTURES, SELLS AND SUPPORTS COMPUTER GRAPHICS SYSTEMS. THESE SYSTEMS USE COMPUTER TECHNOLOGY TO FACILITATE ARCHITECTURAL, ENGINEERING, CONSTRUCTION AND GEOLOGICAL DESIGN AND DRAFTING PROCESSES. USING COMPUTER GRAPHICS, AN ARCHITECT, FOR EXAMPLE, CAN DESIGN A STRUCTURE AND

CREATE A THREE DIMENSIONAL IMAGE THAT CAN BE EVALUATED AND ALTERED AT WILL -- SAVING WEEKS OF DRAFTING TIME AND THOUSANDS OF DOLLARS.

THIS IS A HIGHLY COMPETITIVE, RAPIDLY EVOLVING BUSINESS. TO STAY IN THE FOREFRONT OF THE INDUSTRY -- AN INDUSTRY IN WHICH THIS NATION LEADS THE WORLD -- INTERGRAPH MUST CONSTANTLY IMPROVE ITS PRODUCTS. IN ORDER TO DO THIS, THE COMPANY SPENDS A LARGE SHARE OF ITS INCOME ON RESEARCH AND PRODUCT DEVELOPMENT, AS MUCH AS $10 MILLION THIS YEAR ALONE.

INTERGRAPH OPERATES FACILITIES FINANCED WITH RECENT IDB ISSUES AMOUNTING TO $5½ MILLION AT INTEREST RATES RANGING FROM 7.75% TO 9%. IF THE COMPANY UNDERTAKES ITS NORMAL AMOUNT OF RESEARCH AT ANY TIME IN THE NEXT THREE YEARS, THE BONDS WILL LOSE THEIR TAX-EXEMPT STATUS AND THE INTEREST RATE WILL REVERT TO 2% OVER PRIME--MORE THAN 20%. YOU CAN EASILY SEE HOW THIS CREATES A POWERFUL DISCENTIVE TO UNDERTAKING THE RESEARCH THAT THIS COMPANY AND THAT ALL OF AMERICAN INDUSTRY NEEDS.

INTERGRAPH IS NOT ALONE IN THIS SITUATION. SMALL, INNOVATIVE COMPANIES THROUGHOUT THE NATION WHICH DEPEND UPON R&D TO KEEP THEIR PRODUCTS CURRENT AND COMPETITIVE CANNOT USE IDBS TO FINANCE THEIR PLANT AND EQUIPMENT. IT IS FOR THIS

REASON THAT THE AMERICAN ELECTRONICS ASSOCIATION, ON BEHALF OF THE NATION'S ELECTRONICS INDUSTRY, SUPPORTS S. 1472.

IN ADDITION TO ITS ADVERSE IMPACT ON RESEARCH, THE CURRENT RULE NEEDLESSLY COMPOUNDS THE BUREAUCRATIC BURDEN UPON BUSINESSES. SECTION 174 WAS INTENDED TO END THE NEED FOR COMPANIES TO SEPARATE THEIR RESEARCH AND DEVELOPMENT EXPENSES FROM NORMAL OPERATING EXPENSES, AND AVOID REPEATED AUDITS AND CHALLENGES ON THIS POINT. THE TREATMENT OF IDB'S RAISES THESE PROBLEMS ALL OVER AGAIN. A BUSINESS WHICH USES AN INDUSTRIAL DEVELOPMENT BOND MUST ANALYZE ALL OF ITS EXPENDITURES IN THE PRECEDING 3 YEARS, SEPARATING OUT RESEARCH, AND MUST SEGREGATE RESEARCH EXPENDITURES FOR THE SUBSEQUENT 3 YEARS AS WELL. AND BECAUSE THIS DETERMINATION CAN ALWAYS BE CHALLENGED, THE BOND ISSUE'S TAX EXEMPTION MAY BE UNCERTAIN.

MY BILL OFFERS A SIMPLE SOLUTION TO THESE PROBLEMS. IT PROVIDES THAT RESEARCH AND EXPERIMENTAL COSTS WHICH ARE TREATED AS EXPENSES FOR THE PURPOSES OF SECTION 174 SHALL ALSO BE EXPENSES FOR THE PURPOSES OF THE "SMALL-ISSUE EXEMPTION" UNDER SECTION 103(B)(6). BY DOING SO, THE BILL PROVIDES UNIFORM TREATMENT FOR RESEARCH AND DEVELOPMENT EXPENSES IN THE CODE, AND AVOIDS THE UNCERTAINTY AND UNNECESSARY ACCOUNTING PROBLEMS CREATED BY THE PRESENT IRS POSITION. THE BILL WILL PERMIT

FIRMS WHICH USE IDB FINANCING TO CARRY OUT NORMAL RESEARCH AND EXPERIMENTATION ACTIVITIES, AND IT WILL PERMIT THOSE HIGH TECHNOLOGY FIRMS WHICH DEPEND HEAVILY ON RESEARCH AND INNOVATION TO BENEFIT FROM TAX-EXEMPT FINANCING.

THE BILL'S REVENUE IMPACT WILL BE NEGLIGIBLE. THE RESEARCH AND DEVELOPMENT EXPENDITURES TO WHICH IT WOULD APPLY CANNOT THEMSELVES BE FUNDED OUT OF THE PROCEEDS OF AN INDUSTRIAL DEVELOPMENT BOND ISSUE. IDBS BASICALLY CAN ONLY FUND CAPITAL COSTS FOR PLANT AND EQUIPMENT. THUS THE NUMBER AND SIZE OF IDB ISSUES SHOULD NOT INCREASE SIGNIFICANTLY. HOWEVER, THIS VALUABLE LOW-COST FINANCING TOOL WILL CEASE TO BE DENIED TO THOSE COMPANIES WHICH HELP TO ADVANCE AMERICAN TECHNOLOGY AND INDUSTRY SOLELY BECAUSE OF THEIR HIGH RESEARCH COSTS.

I UNDERSTAND THAT THE ADMINISTRATION DOES NOT OPPOSE ENACTMENT OF THIS BILL. MR. EIZENSTAT ADVISES ME THAT HE HAS DISCUSSED THIS ISSUE DIRECTLY WITH ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY JOHN CHAPOTON, WHO ASSURED HIM THAT TREASURY WOULD NOT OBJECT TO THE PROVISION.

THIS IS NOT A PARTISAN OR REGIONAL ISSUE. SENATOR MOYNIHAN INTRODUCED LEGISLATION TO RESOLVE THE PROBLEM IN THE PREVIOUS CONGRESS, AS WELL AS THIS ONE. REPRESENTATIVE SHANNON

OF MASSACHUSETTS HAS INTRODUCED THE COMPANION BILL TO MINE IN THE HOUSE.

I WOULD NOTE THAT WHILE CERTAIN USES OF INDUSTRIAL DEVELOPMENT BONDS HAVE BEEN THE SUBJECT OF CONCERNS EXPRESSED IN OVERSIGHT HEARINGS BEFORE THE HOUSE WAYS AND MEANS COMMITTEE, THESE CONCERNS DO NOT MILITATE AGAINST THE BILL I HAVE INTRODUCED. INDEED, THEY POINT UP THE NEED FOR THIS LEGISLATION. OBJECTIONS HAVE BEEN RAISED TO THE USE OF IDBS BY BIG NATIONAL CORPORATIONS TO ESTABLISH FRANCHISES IN A NUMBER OF AREAS, OR TO FINANCE SHOPPING CENTERS, FAST FOOD OUTLETS AND RETAIL STORES. THESE USES, IT IS ARGUED, ARE CONTRARY TO CONGRESS'S INTENT THAT IDBS BE USED TO PROMOTE GROWTH BY LOCAL BUSINESSES, AND TO STIMULATE MANUFACTURING AND PRODUCTION.

WITHOUT CONCEDING THE VALIDITY OF THESE OBJECTIONS, I WOULD POINT OUT THAT THE CURRENT TREATMENT OF RESEARCH AND DEVELOPMENT COSTS FOR IDB PURPOSES TENDS TO AGGRAVATE THIS SITUATION, DISCOURAGING MANUFACTURERS AND LOCALLY-BASED BUSINESSES. A RETAILER NEED NOT WORRY ABOUT PRODUCT DEVELOPMENT OR EXPERIMENTATION; HIS MAIN CAPITAL EXPENDITURE IS FOR THE BUILDING, WITH PRODUCT AND LABOR COSTS COMING OUT OF EXPENSES. A MANUFACTURER, ON THE OTHER HAND, PARTICULARLY ONE IN THE HIGHLY COMPETIVIVE, NEW TECHNOLOGY FIELDS, MUST CONSTANTLY

IMPROVE AND DEVELOP HIS PRODUCT, SPENDING SUBSTANTIALLY FOR RESEARCH, THEREBY RUNNING INTO THE CAPITAL EXPENDITURE LIMITATION. SIMILARLY, A NATIONAL CORPORATION HAS CONSIDERABLE LATITUDE TO ALLOCATE OR DISPERSE ITS RESEARCH ACTIVITIES IN SUCH A FASHION AS TO AVOID HITTING THE EXPENDITURE LIMITATION WITHIN ANY ONE JURISDICTION. A CONCERN LOCATED IN A SINGLE AREA HAS NO SUCH LEEWAY. THUS, REGARDLESS OF WHAT THE CONGRESS ULTIMATELY DECIDES TO DO ABOUT INDUSTRIAL DEVELOPMENT BOND FINANCING, THIS LEGISLATION WILL HELP TO ENCOURAGE THE MOST PRODUCTIVE USE OF IDBS.

IN CONCLUSION, I WANT TO POINT OUT ONE TECHNICAL CHANGE THAT SHOULD BE MADE IN THE BILL AS INTRODUCED. THE BILL WAS INITIALLY DRAFTED WITH AN EFFECTIVE DATE THAT WOULD COINCIDE WITH THE PROPOSED EFFECTIVE DATE OF THE BUSINESS PROVISIONS OF PRESIDENT REAGAN'S TAX CUT BILL. SINCE THAT BILL HAS BEEN ENACTED, I WOULD NOW RECOMMEND THAT S. 1472 BE MADE APPLICABLE TO ALL EXPENDITURES FOR RESEARCH AND EXPERIMENTATION AFTER THE DATE OF ITS ENACTMENT. TO ASSURE AN IMMEDIATE BENEFICIAL IMPACT, THE BILL SHOULD APPLY TO RESEARCH AND DEVELOPMENT EXPENDITURES BY COMPANIES ALREADY OPERATING UNDER IDBS, AS WELL AS TO EXPENDITURES UNDER NEW BOND ISSUES. THIS WOULD NOT VALIDATE BOND ISSUES THAT HAVE ALREADY BEEN RULED TAXABLE OR

EXPENDITURES THAT HAVE ALREADY BEEN MADE. BUT IT WOULD REMOVE THE DISINCENTIVE TO RESEARCH AND DEVELOPMENT ACTIVITIES BY COMPANIES USING IDBS AS OF ITS EFFECTIVE DATE. I REQUEST PERMISSION TO SUBMIT FOR THE RECORD A PROPOSED AMENDMENT TO S. 1472 WHICH WOULD ACCOMPLISH THIS.

MR. CHAIRMAN, I APPRECIATE YOUR COURTESY IN ALLOWING ME TO TESTIFY THIS MORNING, AND I URGE YOU TO GIVE PROMPT FAVORABLE CONSIDERATION TO S. 1472. THANK YOU.

Senator PACKWOOD. Stu, it is good to have you with us.

STATEMENT OF MR. STUART E. EIZENSTAT, ATTORNEY FOR THE INTERGRAPH CORP. OF HUNTSVILLE, ALA.

Mr. EIZENSTAT. Thank you, Mr. Chairman.

There are a few points, and I will try not to be repetitious of Senator Denton's excellent statement in explaining the need of S. 1472 and what it would accomplish.

It seems to me clearly it is a policy of good commonsense to remove discrimination against high-technology companies, which is in effect what the current IRS treatment of research and development for IDB purposes does.

I think it would be useful, Mr. Chairman, very briefly to talk about the reason section 174, which is to be the focus of this amendment, was passed to begin with.

Prior to passage of the rule in section 174 permitting R. & D. costs to be expensed, the IRS treated research costs as capital expenditures. They treated it in effect as business building, thus companies could not deduct the salaries paid and materials provided for staff involved in researching new products, rather than manufacturing existing ones.

This created, Mr. Chairman, serious accounting and legal problems as taxpayers and the Service struggled to determine whether a person was actually engaged in research or production, and how to allocate time and expenses between those two functions.

It also discouraged research and development, since companies were reasonably reluctant to pay salaries and expenses that could not immediately be deducted.

In effect, Mr. Chairman, wages paid to a bookkeeper or janitor were expenses to be immediately deducted, but wages paid to engineers or scientists for research could only be capitalized.

As a result to the disincentive of R. & D. and the tremendous administrative burden created, Congress passed section 174, which permitted a company to deduct the salaries and materials involved in research and experimentation, just like other salaries.

Companies which performed a substantial amount of research and development now did not have to create an artificial and separate account for salaries to their employees. All could be expensed.

The IRS ruling at issue here under section 103(h) had the effect, Mr. Chairman, of frustrating the intent of section 174 and throwing us back to the pre-section 174 days for one and only one class of R. & D. expenditures, that is those in the context of industrial development bonds.

This frustrates the purposes of the IDB limit on capital expenditures and puts taxpayers and the IRS back in the business of determining which expenses are for research and development and which are for production.

The legislation introduced by Senator Denton would therefore carry out the intent of Congress in initially passing section 174 and would simply permit all R. & D. expenses which could otherwise be deducted as expenses under section 174, to be treated the same way.

It would remove the disincentive for R. & D. companies to use IDB's in the same way that other companies can use them.

I would stress that S. 1472 will not permit companies to expense actual capital costs, such as land, plant, and equipment, simply because they may be used for research.

Section 174(c) explicitly denies expensing of this type of depreciable asset.

The bill would simply permit the expensing of costs such as salaries, that would normally but for their characterization as research, be deductible.

Similarly, the bill would not permit these research costs to be funded out of IDB's. It does not create any loophole in that regard.

Section 103(b)(6) makes IDB financing available only to land and depreciable property, the type of costs which are already excluded from section 174 treatment.

Thus the proceeds of IDB financing must be used for depreciable capital expenditures.

Finally, and in conclusion, there has been some concern about the appropriate effective date of the bill, specifically over whether it should apply to all expenditures for R. & D., after the date of enactment, or only to R. & D. expenditures under bonds issued after the date of that.

As Senator Denton has pointed out, the bill should apply to all R. & D. expenditures after the date of enactment, regardless of when the IDB's in question were used, because the purpose is to remove an unintended and unwise disincentive to research.

It should do so for future R. & D. expenses by all companies operating under IDB's, not just for newly issued ones.

Indeed, if the rule were only applicable, Mr. Chairman, with respect to expenses with respect to bonds issued after date of enactment, we would have a situation in which companies operating under two IDB's, one issued before the bill and one after, would be counting R. & D. costs as capital expenditures for the first issue and expenses for the second.

This amendment is important then, in conclusion, to remove a disincentive to R. & D., which I think was not intended, and it is for this reason it is supported by groups such as the American Electronics Association, to eliminate an administrative burden both to R. & D. companies and to the Internal Revenue Service, and to do so at virtually no cost.

Regardless of what Congress does with IDB's, and this is the point to which you were referring at the outset, Mr. Chairman, regardless of what Congress does with IDB's in the future, whether to expand them or to restrict them, there will presumably be some use made of IDB's, and as Mr. Chapoton had indicated to me, at our earlier meeting, it makes no sense to have a provision in which research and development is treated unfavorably.

Indeed it is precisely this type of bill, with a very negligible revenue impact, for which miscellaneous tax measures are necessary.

It will get lost in the shuffle if it must be part of a comprehensive treatment of IDB's because it is clear there is no consensus on industrial development bonds, while there is a consensus on this bill.

Intergraph, my client, and similar R. & D. companies, are literally bleeding from the IRS interpretation. More delay would be unfair. It is for this reason that I urge prompt action on this bill, and again, Mr. Chairman, I am most appreciative of your kind attention.

Senator PACKWOOD. Stu, thank you very much for coming. It is good to see you again.

Mr. EIZENSTAT. Thank you.

Senator PACKWOOD. Our next witness is the Honorable John E. Chapoton, Assistant Secretary for Tax Policy of the Department of the Treasury.

Welcome to the committee, Mr. Secretary.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY OF THE DEPARTMENT OF THE TREASURY

Secretary CHAPOTON. Thank you, Mr. Chairman.

Senator PACKWOOD. Now, Mr. Secretary, I am curious just as an aside on what you are recommending on revenue bonds in particular.

Secretary CHAPOTON. Mr. Chairman, let me go to that point while it is fresh in our minds and cover this matter that Mr. Eizenstat and the Senator referred to.

It was on the list of items on the fact sheet last night that we were, that I am led to understand that it was limiting the industrial development bond area in general.

We are studying very significant limits on the entire area. We do not yet want to put forth a specific proposal, and we will be doing so within a couple of weeks.

We are concerned though about the significant growth in small issue IDBS and others as well.

Let me, on the Senator's bill, let me just mention as Mr. Eizenstat and the Senator mentioned, we looked at this, we think that probably the rule—that is you deduct R. & D. expenses, or whether or not you deduct R. & D. expenses, where they count against the $10 million limit—probably does not make any sense, because one of the problems with R. & D. expenses is knowing what portion is R. & D. and what portion is not, and the deduction removes the necessity to make that allocation, so we as I told them would have no objection to such a change.

We would not want to have that treated as any precedent for other expenses that may be deductible, but are capital in nature for this purpose, and we also suggested the nonretroactivity point that I see they have agreed to, and we also would want to make it clear this would apply to labor and supplies.

I do not think it would apply to capital equipment, but we would want to make certain about that.

In our testimony in the written statement, I believe that we are stating that it seems to make sense.

We are going to have a proposal in the entire area, and it seems to me that this should be considered, the basic questions, and these peripheral issues that arise should be all considered together, and there are a lot of peripheral issues in the IDB area in general.

Let me now turn to the other bills before the subcommittee this morning, first S. 578 and S. 1276, section 1 of both of those bills would in effect overrule a decision by the Supreme Court in early 1979, which stated, basically, that excess inventory, even if written down for financial accounting purposes, may not be written down, and taken as a deduction for Federal income tax purposes, unless the inventory is actually scrapped or offered for sale at the reduced price.

Let me give a little background on this, because this is an important issue, and it is an issue that has concerned a lot of taxpayers, and there has been a good deal of controversy about it, and so I do think we need to give it very serious attention, and this subcommittee does also.

The need to account for inventories is of course a fundamental principle of our tax system. Inventories are required for both financial and tax accounting purposes to match the cost of goods with the revenue obtained from their sale. Income is distorted whenever costs are recognized in a different period than the income to which they relate.

Another fundamental principle of our income tax system is that gain or loss of property is recognized only when it is realized when the property is sold or otherwise disposed of.

Inventory accounting determines the cost of goods sold in a particular period, thereby insuring that for such accounting period, the proper costs are matched with the revenue of that period.

The value of ending inventory plays a pivotal role in determining gross income. To the extent that ending inventory is over-valued or under-valued, gross income is over-stated or under-stated accordingly. Thus we feel strongly that an objective standard is needed to determine ending inventory valuation.

The income tax regulations have been in effect for more than 50 years permitting taxpayers who elect to use the FIFO—First-In First-Out—method of accounting, to value normal inventory at cost or the lower of cost or market.

Market is generally defined as replacement cost. The use of the lower of cost or market method is a limited exception to the general principle that taxable income is based on realized gains and losses and therefore its use, we think, must be strictly limited.

To provide otherwise would permit taxpayers to pay virtually any tax they want. Therefore the regulations provide that normal inventory can be valued at market if lower than actual cost, and

can only be valued below replacement cost if actually scrapped, which of course is a realization event, or actually offered for sale at a lower price. Both of these are objective standards.

In *Thor*, as I mentioned, the taxpayer claimed that it had excess inventory on hand, which it would not be able to sell in the normal course of its business.

The Thor Power Tool Co. utilized scrap value as the inventory value of its excess inventory. The write-down of the inventory from cost to scrap was based on the judgment of the company's officers that the on inventory on hand exceeded what they foresaw as future demand.

In a unanimous nine to zero decision, the Supreme Court affirmed the decision of the Court of Appeals for the Seventh Circuit and the Tax Court and concluded that, although the taxpayer's method of accounting was consistent with the best accounting practice, it did not clearly reflect income and was, in the words of the Court, plainly inconsistent with the applicable regulations.

The taxpayer argued that the financial accounting rules required the write-down of excess inventory and, that these rules were presumptively appropriate for tax purposes. However, the Court found this argument not supportable because of the different objectives of financial and tax accounting.

The Court stressed the need for an objective standard for inventory devaluation, again quoting of the "well-known potential for tax avoidance that is inherent in inventory accounting."

The primary issue for this subcommittee to consider is whether it is appropriate to reduce income by unrealized losses on inventory where the taxpayer continues to sell the inventory at full price.

It is our position that in such cases no reduction is appropriate. We believe the approach taken by the regulations and upheld in the *Thor* case by the Supreme Court is appropriate, and thus we oppose both of the bills in this regard.

As stated, we think inventories are necessary for a proper matching of expense and revenue, and to permit a write-down on less than an objective standard will allow distortion of income.

To permit the write-down with respect to inventory which is offered for sale for sale at normal prices would allow taxpayers to recognize an unrealized loss with respect to such inventory when the inventory in question is still being offered and can be sold at a profit.

If the taxpayer is still selling his inventory at full price, we do not understand why for tax purposes its fair market value should be considered less than that price.

Proponents of the legislation before you, Mr. Chairman, argue that a taxpayer has a real loss with its current inventory which it cannot prove under current law without scrapping the inventory. We are aware of the articles alleging that the *Thor* decision will cause publishers to burn books and manufacturers to scrap their spare parts.

We think such arguments are an exaggeration, a great exaggeration. There are a number of publishing companies and many, many other taxpayers who have been in compliance with the inventory rules stated in the regulations and upheld by the *Thor Power* case for years.

How much inventory to buy, and whether certain inventory can be sold is primarily a business decision. If the inventory is offered and sold at a lower price, the loss may be recognized. If the inventory is being offered and sold at a profit, we do not think any loss has been realized and this should not be recognized for tax purposes.

If the subcommittee should consider it appropriate to grant some relief, some change in the long-standing inventory rules, I just want to point out that the method provided in S. 1276 we think such a rule is particularly inappropriate. If would permit taxpayers to simply write off inventory merely because it has been held for more than 12 months.

This would in effect permit taxpayers to depreciate inventory, and we do not think such a rule can be rationalized on any principle of tax or financial accounting.

S. 578 by contrast attempts to measure the write-down on the basis of the taxpayer's particular history, which is some standard, although, of course, it is a subjective and not an objective standard.

Section 2 of S. 1276 would simply delay the effective date of IRS pronouncements issued to implement the *Thor Power* decision.

We would oppose this proposal basically for the reasons I have outlined in my written testimony.

The proponents of the delay proposal in both bills—S. 578 and S. 1276 both effectively have delay provisions—argue that the IRS issued the pronouncements in question, which implemented the Supreme Court's 1979 decision, in 1980, effective for 1979, and therefore they did not have ample notice or time to comply with the Supreme Court's decision as required by the pronouncements.

We have taken the position that the *Thor Power* decision simply upheld the existing regulations, that the taxpayers were clearly on notice of the requirement in the regulations, and that the IRS in issuing the ruling and the revenue procedure in 1980 was simply stating what was already known to be the law. Without going into detail, the IRS in issuing the pronouncements was dealing with a position maintained by certain taxpayers that they did not have to comply with the Supreme Court's decision based on technical argument.

Turning to a different inventory question, section 2 of S. 578, would repeal the current law requirement that taxpayers that use the last-in, first-out, that is the LIFO, method of accounting for inventory for tax purposes must also use that method for purposes of reporting to shareholders, partners, other proprietors or beneficiaries and for purposes of obtaining credit.

This is a LIFO conformity requirement that has been stated in the law for many, many years. It is much objected to by business as unnecessary.

We have reviewed arguments pro and con in the written statement.

There are indeed some arguments for doing away with the LIFO requirement. I think there are also sound arguments that deserve full consideration for keeping the LIFO conformity requirement.

Unfortunately at this time I think the only thing we can state is that we must oppose repeal of the LIFO conformity requirement because of the revenue consequences of repealing it.

Whether right or wrong, the conformity requirement has the practical effect of restricting taxpayers that do not want to use LIFO for financial accounting purposes because it would reduce the income reported for financial purposes from using it for tax purposes.

If Congress did away with the conformity requirement, and all taxpayers were allowed to switch, we would estimate that the revenue loss would eventually reach $8 billion a year, and for that reason we must oppose doing away with the conformity requirement at this time, and as I stated, we are not ready to concede that the conformity requirement is not correct, though we do concede that there are valid arguments on both sides of this question.

I also mention in the written statement that there is a recent Tax Court case that was affirmed in the Second Circuit, the *Insilco* case, which would basically render a conformity requirement a nullity simply because it allows the conformity requirement to be overcome if the operating entity forms a holding company. It says the holding company can report without regard to the conformity requirement. The effect if that decision were upheld would be to pretty well dissipate the conformity requirement of the law without further legislation.

We think that the IRS will continue to resist the *Insilco* case, but we think indeed this subcommittee and the Congress might wish to clarify and clear the air on this and the uncertainty which could result while this question is being litigated and make it clear that so long as we have the conformity requirement, it will remain fully applicable, and that the *Insilco* decision is not correct.

Section 3 of S. 578 would permit a 10-year spread of the cost or the additional tax cost of switching from FIFO to LIFO. Basically a taxpayer that is on the FIFO method, if he wishes to switch to LIFO, must return to income previous deductions claimed on using the lower of cost or market to the extent he has reduced his inventory to market in earlier years. Since the lower of cost or market may not be used in connection with LIFO inventory, he must restore to income, the previously claimed deduction, the previous write-down in going to cost value for LIFO inventory.

The question here is the period over which that restoration of income for the previous write-downs must be taken. The prior law said it had to be in 1 year. In the recent 1981 act, a provision was added saying the write-down may be returned to income over a 3-year period, section 3 of S. 578 would permit the write-down to be returned to income over a 10-year period.

We oppose this provision as to the spread. We did support the 1981 act provision which allows the spread over 3 years. We thought it was appropriate to mitigate the effect of the tax cost of adopting LIFO, but we think a 10-year period is much too long.

We conducted an informal study, and we found that usually the tax benefit derived from going to LIFO offsets the tax costs resulting from any initial income adjustment in the first year, and that this turnaround time is almost never more than 3 years. Therefore, we feel that a 10-year period is much too long.

Mr. Chairman, I have covered already the small IDB area, so that concludes the summary of our statement.

I would be happy to answer any questions.

Senator PACKWOOD. Mr. Secretary, I have no questions.

These are two issues that are not new to this committee, and we have gone through them in previous years, but I appreciate your coming up and making a statement.

Secretary CHAPOTON. Thank you.

[Prepared statement of Secretary Chapoton follows:]

9:30 A.M.
9/25/81

STATEMENT OF JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the following bills: S. 578 and S. 1276 providing for changes in the rules with respect to inventory accounting; S. 768 and S. 1472 concerning the capital expenditures limitation on small issue industrial development bonds.

After setting out a summary of each bill and the position of the Treasury Department with respect to it, I will discuss each proposal in detail.

Summary

Section 1 of S. 578 and section 1 of S. 1276 represent two different responses to the Supreme Court's 1979 decision in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979), involving the proper method of accounting for excess inventory. Section 1 of S. 578 would allow taxpayers to write-down excess inventory to its net realizeable value based on the taxpayers' most recent 5-year experience. This provision would be effective for taxable years ending on or after December 25, 1979. Section 1 of S. 1276 would allow qualifying small businesses to deduct the carrying value of inventory held for more than 12 months in equal amounts over a three year period effective for taxable years ending after December 31, 1980. A qualifying small business for this purpose would be defined as one which has equity capital which does not exceed $25,000,000. The Treasury Department strongly opposes section 1 of S. 578 and section 1 of S. 1276.

Section 4 of S. 578 and section 2 of S. 1276 would nullify the effect of two IRS pronouncements, Rev. Proc. 80-5 and Rev. Rul. 80-60, issued to implement the Supreme Court's decision in Thor. The Treasury Department strongly opposes section 4 of S. 578 and section 2 of S. 1276.

Section 2 of S. 578 would repeal the current requirement that taxpayers can not elect the Last-In, First-Out ("LIFO") method of accounting for inventories for tax purposes unless that method is used for purposes of reporting to shareholders and creditors. Treasury opposes section 2 of S. 578.

Section 3 of S. 578 would permit taxpayers to spread the income adjustment resulting from an election to use the LIFO method ratably over a 10 year period. Treasury opposes section 3 of S. 578.

S. 768 and S. 1472 would provide that research and experimental expenditures which may be deducted under section 174 even though they are capital in nature, would not be taken into account for purposes of the capital expenditures limitation on small issue industrial development bonds ("IDBs"). Treasury believes the proposal contained in these bills has merit as an isolated question but that the Congress should address the industrial development bond area in a comprehensive rather than peicemeal fashion.

Section 1 of S. 578 and Section 1 of S. 1276 Write-Down of Excess Inventory

I. Role of Inventory

The need to account for inventories is a fundamental principle of our tax system. The primary reason for requiring inventories for financial and tax accounting purposes is to match the cost of goods with the revenue obtained from their sale. Income is distorted whenever costs are recognized in a different period than the income to which they relate. In defining gross income, section 61 of the Internal Revenue Code includes "gains from dealing in property." Thus, gross income includes the net difference between the amount received on a sale and the cost of the property to the seller. Another fundamental principle of our tax system is that gain or loss on property is recognized only when it is realized when the property is sold or otherwise disposed of.

Inventory accounting determines the cost of goods sold in a particular period, thereby insuring that for such accounting period, the proper costs are matched with the revenue of the period. Beginning inventory represents the expenditure of a prior period which relates to income to be realized in the current or future period. Ending inventory represents an expenditure of the current period or a past period which relates to income to be realized in the future.

The impact of inventory on the computation of gross income can be illustrated by the following example:

Gross Sales			$100
Less:	Cost of Goods Sold:		
	Beginning Inventory	$20	
	Plus: Purchases	50	
	Cost of Goods Available for Sale	70	
	Less: Ending Inventory	10	
	Cost of Goods Sold		60
Gross Income			40

If the value of ending inventory in the above example were increased by $10, gross income would have been increased by this same amount, computed as follows:

Gross Sales			$100
Less:	Cost of Goods Sold:		
	Beginning Inventory	$20	
	Plus: Purchases	50	
	Cost of Goods Available for Sale	70	
	Less: Ending Inventory	20	
	Cost of Goods Sold		50
Gross Income			50

As can readily be seen, the value of ending inventory plays a pivotal role in determining gross income. To the extent ending inventory is overvalued or undervalued, gross income will be overstated or understated accordingly. Thus, an objective standard is needed to determine inventory value to assure that income is clearly reflected.

Inventories may be accounted for on either the Last-In, First-Out ("LIFO") method or on the First-In, First-Out ("FIFO") method. The LIFO and FIFO methods are assumptions as to the flow of goods. Under FIFO, the first goods purchased (or manufactured) are presumed to be the first

goods sold. Under LIFO, the last goods purchased (or manufactured) are presumed to be the first goods sold. In times of inflation, the LIFO method permits the matching of the most recent, highest cost inventory with current sales, thus deferring the taxation of income that will result from matching the earlier, lower cost inventory with sales.

Income tax regulations which have been in effect for more than 50 years permit taxpayers who elect to use the FIFO method of accounting for inventory to value normal inventory at cost or at the lower of cost or market. "Market" generally is defined as replacement cost. The use of the lower of cost or market method of inventory valuation for tax purposes is a limited exception to the principle that taxable income is based on realized gains and losses. The lower of cost or market method is based on the rule of conservatism, a primary postulate of generally accepted accounting principles used for financial statement reporting. However, while the lower of cost or market method has long been allowed as an acceptable practice for tax purposes as an exception to a fundamental principle, the use of the method must be strictly limited. To provide otherwise would virtually permit taxpayers to pay any tax they want. Therefore, the regulations provide that normal inventory can be valued at market if lower than actual cost, and can only be valued below replacement cost if actually scrapped (a realization event) or actually offered for sale at a lower price, both objective standards.

The Thor Decision

The issue in Thor involves the proper method of accounting for so-called "excess" inventory -- that is, that portion of goods on hand that a taxpayer believes it will not sell in the normal course of business. The Thor Power Tool company utilized scrap value as the inventory value of its excess inventory. The write-down of the inventory from cost to scrap value was based on the judgment of company officers that the inventory on hand was greater than reasonably forseeable future demand and, thus, that it was appropriate to recognize a loss with respect to these excess goods. However, the taxpayer continued to offer for sale its excess inventory and to make sales of such inventory at the usual list price. The write-down reduced the total value of the taxpayer's ending inventory. Gross income and taxable income, were thus, reduced accordingly.

In its unanimous 9-0 decision, the Supreme Court affirmed the decision of the Court of Appeals for the Seventh Circuit and the Tax Court and concluded that, although the taxpayer's method was consistent with the best accounting practice, it did not clearly reflect income and was "plainly inconsistent with the applicable regulations." The taxpayer argued that financial accounting rules required the write-down of excess inventory and that these rules are presumptively appropriate for tax purposes. However, the Court found this argument unsupportable due to the different objectives of financial and tax accounting. The Court stated:

> "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets.' In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

Moreover, the Court stressed the need for objective standards for inventory valuation because of the "well-known potential for tax avoidance that is inherent in inventory accounting." The Court stated:

> "If a taxpayer could write down its inventories on the basis of management's subjective estimate of the goods' ultimate salability, the taxpayer would be able, as the Tax Court observed [at P. 120], to determine how much tax it wanted to pay for a given year."

The Proposed Legislation

Both S. 578 and S. 1276 would permit the write-down of excess inventory under two very different approaches. S. 578 would permit a taxpayer to write-down its inventory on the basis of historical experience. S. 1276 would permit taxpayers to write off inventory held for more than 12 months over a three-year period.

The primary issue for this Subcommittee to consider is whether it is appropriate to reduce income by unrealized losses on inventory where the taxpayer continues to sell the inventory at full price. It is Treasury's position that in such cases no such income reduction is appropriate. We believe that the approach taken by the regulations upheld by the Supreme Court in Thor is correct and thus we strongly oppose both bills.

As indicated above, inventories are required in order to match revenue and expense for a proper measurement of taxable income. To permit taxpayers to write down or write off inventory results in income distortion since expenses are recognized prior to the income to which they relate.

Moreover, to permit such write-downs or write-offs with respect to inventory which is offered for sale at normal prices allows taxpayers to recognize an unrealized loss with respect to such inventory when the inventory in question can still be sold at a profit. Again, the regulations permit a write-down where inventory is offered for sale at a price below cost. Indeed, to allow recognition of unrealized losses violates one of the fundamental principles of our tax system regarding the recognition of income and increases the potential for manipulation and abuse inherent in the area of inventory accounting. If a taxpayer is still selling his inventory at full price, we do not understand why, for tax purposes, its fair market value should be considered less than that price. As the Supreme Court said in Thor, there is "no reason why [the taxpayer] should be entitled for tax purposes to have its cake and eat it too."

We also believe that the issue of inventory write-downs is only one side of a two-sided coin. If one argues that the unrealized losses on inventory should be recognized prior to the time such inventory is sold, should it not also be argued that unrealized gains on goods in inventory should be recognized as well?

Proponents of this proposed legislation to reverse the Supreme Court decision argue that a taxpayer may have a real loss with respect to its inventory which it cannot prove under current law without scrapping that inventory. We are aware of the media articles which allege that the Thor decision will cause publishers to burn their books and manufacturers to scrap their spare parts. However, we believe the problems have been greatly exaggerated. It should be noted that a number of publishing companies have been in compliance with the inventory methods upheld in Thor for years.

Further, how much inventory to buy and whether certain inventory can be sold is primarily a business decision. If inventory is being sold at a profit, we do not believe that any loss has in fact been realized. Indeed, we believe the usual reason why a taxpayer is unable to prove under the regulations that its inventory has declined in value is that no loss has in fact occurred.

On the other hand, if there are situations where the regulations impose a great hardship, we would be willing to consider a rule exempting taxpayers in such hardship cases.

We also recognize that overvalued inventories can contribute substantially to the impact of inflation on business profits and that businesses which must invest heavily in inventory need some relief in today's inflationary times. However, it is Treasury's position that this relief should come in the form of amending current rules with respect to the LIFO method to make that method more accessible to all businesses. We have taken steps in this regard. For instance, the LIFO conformity rules, which I will discuss in more detail later, have been significantly liberalized. Regulations which would simplify the indexing and pooling rules have been proposed and should be published in final form by the end of this year. Other possibilities for reform and simplification are under consideration as part of the study mandated by the Economic Recovery Tax Act of 1981.

Treasury believes that the LIFO method provides adequate relief for taxpayers whose businesses require a large investment in inventory. We have not ignored this area but rather have and will continue to work to improve current rules with respect to inventory accounting.

It should also be noted that the problem of market write-downs does not apply to taxpayers using LIFO since the Internal Revenue Code does not permit the lower of cost or market method in conjunction with the use of LIFO.

However, if, despite our strong objections, Congress determines that it is appropriate to grant the type of change suggested by the legislation presently before this Subcommittee, we would have to suggest that the method proposed in S. 1276 is particularly inappropriate. S. 1276 would permit taxpayers, without any justification, to write-off inventory merely because it has been held for more than 12 months. This provision would, in effect, permit taxpayers to depreciate inventory and can not be rationalized on the basis of any principle of tax or financial accounting. S. 578 by contrast attempts to measure the write-down on the basis of the taxpayer's particular history.

Nevertheless, it is our position that unrealized losses on normal inventory which can be sold at a profit should not be recognized for tax purposes. To allow such losses to be recognized would result in income distortion, would violate a fundamental principle of our tax system regarding the recognition of income, and would increase the potential for manipulation and abuse in the area of inventory accounting.

Section 2 of S. 1276, Delay of Effective Date of Implementation of Thor Power

Section 2 of S. 1276 would delay the effective date of two Internal Revenue Service pronouncements issued to implement the Supreme Court decision in Thor until taxable years ending after December 31, 1980 at which time the rules for inventory write-downs incorporated in section 1 of S. 1276 would be effective. Section 4 of S. 578 would similarly nullify these two pronouncements by making the effective date of the rules on inventory write-downs apply to taxable years ending on or after December 25, 1979. Treasury strongly opposes these proposals.

Revenue Procedure 80-5 and Revenue Ruling 80-60 provided that taxpayers whose method of accounting for "excess" inventory was not in compliance with the inventory regulations and the Thor decision, had to change to a proper method when they filed their income tax return for their first taxable year ending after December 24, 1979.

The Supreme Court announced the Thor decision on January 16, 1979. By June, 1979, the Internal Revenue Service learned that many taxpayers were not going to comply with the regulations and the Thor decision based on a technical argument advanced by some tax practitioners. These practitioners argued that section 446(e) of the Internal Revenue Code provides that taxpayers may not change their method of accounting without receiving consent of the Commissioner. Therefore, since consent had not been requested and received, taxpayers should continue using their improper method of accounting (subject to change if audited) and need not voluntarily change to a proper method of accounting in accordance with IRS procedures.

In order to implement the Thor decision in the face of this technical argument for non compliance with the Supreme Court's decision, the IRS issued Rev. Proc. 80-5 and Rev. Rul. 80-60 on February 8, 1980. Rev. Proc. 80-5 grants the consent needed under section 446(e) for taxpayers to change to a proper method of accounting for "excess" inventory (in compliance with Thor) in filing their income tax return for the first taxable year ending after December 24, 1979. Rev. Rul. 80-60 holds that since consent has been granted, taxpayers using an improper method are required to change to a proper method. This is the first time the IRS used this type of procedure to require compliance with a proper method of accounting. In 1980, the IRS received change of method forms from over 1,700 taxpayers representing a total income adjustment of over $600 million.

Proponents of S. 578 and S. 1276 argue that the IRS pronouncements (1) were retroactive because they were issued in 1980 effective for 1979, and (2) failed to provide taxpayers with an opportunity to adjust their inventory practices by the end of 1979. We find such arguments unfounded.

As stated above, the Supreme Court's decision in Thor, which was announced on January 16, 1979, did not in any way change existing tax law but merely affirmed the over 50 year-old inventory regulations and the Commissioner's authority to apply them. Revenue Procedure 80-5 and Revenue Ruling 80-60, issued on February 8, 1980, similarly did not change any substantive law but merely implemented the Supreme Court's decision in Thor. The regulations upheld by the Court in Thor permit normal inventory to be written down below replacement cost only if scrapped or offered for sale at a lower price. Any doubt that such regulations were

correct were put to rest on January 16, 1979. Thus, taxpayers who wanted to take a write-down for "excess" inventory had more than 11 months before the end of 1979 to take appropriate steps to qualify for such a deduction. Those who claim otherwise do so based on the questionable suggestion that they believed the IRS would not fully implement the Supreme Court decision -- or, if the IRS did implement such decision, that it would not be able to find all affected taxpayers. Some taxpayers could therefore remain in hiding and continue filing tax returns using an improper method of accounting.

The IRS has reacted in a responsible manner to the position of some tax practitioners regarding required compliance with the decision of the Supreme Court. The enactment of section 2 of S. 1276 and section 4 of S. 578 would sanction the past use of an improper method of accounting and could well have the effect of encouraging taxpayers to evade paying tax by using improper methods, such as undervaluing inventory.

In summary, we do not believe that any delay in the effective date of Revenue Procedure 80-5 and Revenue Ruling 80-60 is warranted and strongly oppose enactment of this provision of S. 1276. We similarly oppose the effective date provisions of S. 578.

Section 2 of S. 578, Repeal of Requirement that the LIFO Method Used for Tax Purposes Conform to the Accounting Method Used for Financial Purposes

Section 2 of S. 578 would repeal the current law requirement that taxpayers can not use the Last-In, First-Out ("LIFO") method of accounting for inventory for tax purposes unless they also use that method for purposes of reporting to shareholders, partners, other proprietors or beneficiaries and for purposes of obtaining credit. While we sympathize with some of the arguments advanced by proponents of this legislative proposal, Treasury must oppose it at this time because of the potential large revenue loss which could result from its enactment. We estimate that this revenue loss would eventually be $8 billion per year. In addition, because of this potential revenue loss, we suggest that the Finance Committee should consider legislation to prevent a period of uncertainty in the enforcement of the conformity requirement in light of a recent decision by the Second Circuit Court of Appeals.

The conformity requirement was enacted with the predecessor of section 472 of the Internal Revenue Code in 1939 to ensure that the LIFO method conformed as nearly as might be to the best accounting practice in the taxpayer's trade or business. Apparently, the Congress and the Treasury felt that the LIFO method must not be appropriate for all businesses and, thus, should only be permitted where a taxpayer could demonstrate that LIFO was appropriate for its business by using it in all aspects of that business. Today, LIFO is unquestionably considered consistent with generally accepted accounting principles. Thus, there is merit to the argument that at least the initial reason for requiring conformity may no longer be relevant.

There is also merit to the argument that many corporate taxpayers have been reluctant to adopt the LIFO method despite the fact that they could thereby report less taxable income, in large measure, because they would then also have to report less net profit to their shareholders and creditors. This price is seen as too high by many such taxpayers.

One might also argue that it is not appropriate for the Congress to require certain methods of accounting for financial reporting purposes. While the conformity requirement was enacted to allow the use of LIFO for tax purposes only when the taxpayer can show it is appropriate for financial reporting purposes, in operation it has resulted in corporations making financial reporting decisions strictly on the basis of the effect of those decisions on potential tax benefits. This has resulted in extensive time being spent by company officials, and their accountants and lawyers, in ensuring that all financial disclosures are worded in a way so as not to jeopardize the tax benefits of LIFO. In addition, before the liberalization of the regulations, the LIFO conformity requirement had a chilling effect on full disclosure of useful additional financial information to shareholders.

Treasury has, in the past, been sympathetic to such taxpayer arguments. Income tax regulations published this past winter liberalize the conformity rules in a number of significant ways. Taxpayers may report in an appropriate footnote to their financial statements the value of their inventory and their net profits using a non-LIFO method. In general, the only conformity requirement under the new rules is that LIFO must be used in the taxpayer's primary income statements.

On the other hand, we believe that a sound argument can be made for maintaining the conformity requirement. Taxpayers who argue for repeal are really saying two things. To the Treasury they are saying that non-LIFO methods overstate their income, which would be more clearly reflected on the LIFO method. To everyone else, they would say by their unwillingness to use LIFO for financial statement purposes that the LIFO method understates their income and other accounting methods, therefore, are preferable. The question, thus, becomes whether such taxpayers should be granted the best of both worlds.

In any case, despite the substantive arguments for and against repeal of the conformity requirement, Treasury must, because of the potential revenue loss involved, oppose such repeal at this time. Moreover, we believe that as long as the conformity requirement is the law, it must be enforced. Therefore, we believe the Finance Committee should consider a legislative response to a decision of the Tax Court in Insilco Corporation v. Commissioner, 73 T.C. 589 (1979) as recently affirmed per curiam by the Second Circuit Court of Appeals. In Insilco, the Tax Court held that the conformity requirement was not violated where a parent corporation issues financial statements on a consolidated basis using a non-LIFO method while its subsidiaries use LIFO for tax purposes. The Court reasoned that the Code provides that the nonconforming financial statement or report must be to the taxpayer's shareholders and that the subsidiary's shareholder is the parent and not the parent's shareholders.

Treasury joins the Internal Revenue Service in believing that the Insilco decision was incorrectly decided. It is clear that the decision does not reflect the intent of Congress when the conformity requirement was enacted. It appears to us the Court did not understand the effect of consolidated financial statements. Economically and financially the real shareholders of the subsidiary are the shareholders of the parent. This is reflected by the fact that generally accepted accounting principles allow a parent to include in its earnings the earnings of the subsidiary.

The incorrectness of the decision can be demonstrated by the following example. Assume that a parent company has several wholly owned operating subsidiaries. The parent company has no business activities of its own. Under Insilco, the subsidiaries would be able to use LIFO for tax purposes while the parent reports the results of their operations to its shareholders in its consolidated financial

statements on a FIFO basis. Under these facts, it should be obvious that the relevant shareholders for purposes of the conformity requirement are the parent's shareholders. To hold otherwise renders the conformity requirement meaningless.

The holding in Insilco if accepted by the IRS would provide taxpayers with an easy way around the conformity requirement. Corporations may merely transfer operating assets to newly formed subsidiaries. The subsidiaries could use LIFO for tax purposes while the parent reports its consolidated operations on a non-LIFO basis. If a significant number of companies were to take advantage of the Insilco decision, the revenue effect would be similar to that resulting from repeal of the conformity requirement and could result in a revenue loss of up to $8 billion. In fact, we understand that some taxpayers are in the process of setting up holding companies in order to avoid the conformity requirement on the Insilco theory. The Congressionally mandated conformity requirement would be rendered meaningless without Congressional action.

The IRS intends to continue litigating cases similar to Insilco and we hope the Tax Court will reconsider its position in that case. However, uncertainty will prevail. Therefore, we believe the Finance Committee should consider whether legislation would be appropriate to remove the uncertainty resulting from the incorrect Tax Court decision.

Section 3, S. 578 10-year Spread Permitted for Increases in Inventory Value Required for Adoption of LIFO Method

Under current law, taxpayers using the Last-In, First-Out ("LIFO") method of accounting for inventory must value all inventory at cost. Section 472(d) of the Code requires a taxpayer first electing to use LIFO to value the closing inventory of the preceding taxable year at cost. To the extent that inventories for prior years have been valued on a lower of cost or market basis and market write-downs have actually been effected, the amount of such write-downs must be restored to income. The restoration is accomplished by filing an amended return for the year preceding the year of the LIFO election. This rule was changed by section 236 of the Economic Recovery Tax Act of 1981 effective for taxable years ending after December 31, 1981.

Section 3 of S. 578 would permit taxpayers electing LIFO to spread the income adjustment resulting from that election over a 10-year period. The Treasury is opposed to section 3 of S. 578. We believe the approach taken by section 236 of the Economic Recovery Tax Act is correct and should be maintained. Section 236 of the 1981 Act, accomplishes two things: It allows the income adjustment resulting from the LIFO election to be spread over three years and it obviates the need for filing an amended return.

We supported section 236 of the 1981 Act because it realized that one reason small business has heretofore been reluctant to change to the LIFO method despite the income tax benefits to be derived therefrom is the initial loss of capital caused by the income tax adjustment resulting from such change. We believe that it is appropriate to mitigate the effect of this initial LIFO adjustment. This initial adjustment is conceptually similar to adjustments required by an accounting method change and should be treated in a similar manner.

However, we believe that a 10-year adjustment period is unnecessarily long. An informal study we conducted indicates that for many taxpayers the tax benefit derived from using LIFO exceeds the tax cost resulting from any initial income adjustment in the first year of the LIFO election. For virtually all taxpayers, this "turn-around time" is three years or less. Thus, we feel that a three year spread for the initial income adjustment resulting from an election to use the LIFO method is sufficient.

S. 768 and S. 1472
Capital Expenditures Limitation on Small Industrial Development Bonds

Under present law, interest on IDBs is generally not exempt from Federal income tax since the bond proceeds are used in a private trade or business and payment of the bonds is derived from the business. Exceptions to the general rule of taxability, however, are provided for certain quasi-public "exempt facilities" (such as airports) and for certain "small issues." The small issue exception applies to single issues of $1 million or less, if the bond proceeds are used for land or depreciable property.

At the election of the issuer, the $1 million cap may be increased to $10 million, provided that all outstanding exempt small issues plus other capital expenditures (not

financed out of exempt small issues) within a six-year period with respect to the business project are aggregated for purposes of the limitation. This $10 million cap on the aggregate of prior issues and capital expenditures has the effect of denying tax-exemption to IDBs used in connection with large and expensive projects.

Under Treasury regulations, the amount of capital expenditures is determined under the usual tax rules for distinguishing capital charges from currently deductible expenses. Thus, the research and development costs of developing a new formula, product or other capital asset with respect to the IDB project are capital in nature and now count against the $10 million cap.

The two bills before us would alter this result. They would provide that R&D which the project user may elect to deduct currently under section 174 should not be counted as capital for IDB purposes. Section 174, of course, was originally enacted not to change the general characterization of R&D from capital to non-capital, but only to permit elective deduction because R&D is often hard to define and to distinguish accurately from ordinary deductible expenses, such as wages and materials.

Even though R&D generally is capital in nature, we believe that these proposals to treat it as non-capital for IDB purposes do have some merit. The reason is once again the difficulty of accurately defining and allocating R&D. R&D must be distinguished from other expenditures, and R&D which relates to facilities in one county must be distinguished from R&D relating to other projects outside the county.

If legislation on this point is enacted, we think it is very important that it not serve as a precedent to treat as non-capital other capital items for which elective amortization is permitted. For example, section 179 permits small business to expense small amounts of otherwise capital expenditures. We do not believe the rationale applicable to R&D applies to these other areas.

In addition, several technical points need to be stressed. First, non-capital treatment should apply only where the taxpayer has in fact elected to expense currently under section 174(a), but not if he has chosen not to do so. S. 1472 incorporates this rule while S. 768 does not. Second, it should be made clear that the new rule applies

only to items such as labor and supplies, but does not apply to capital R&D equipment. Third, we think the new rule should only apply to R&D expenditures made after the date of enactment. Both bills before us provide for retroactive change of treatment and are deficient in that regard.

Finally, however, while we believe these bills have some merit, we must oppose a piecemeal aproach to the IDB area. There are numerous and very basic questions presented by the entire area of IDB financing. We think the sounder approach is for this Subcommittee and the Congress to address these basic issues and the peripheral problems they present in a comprehensive fashion.

Senator PACKWOOD. Let me say to the rest of the witnesses, I let the Secretary go on somewhat longer than our normal rule, because I did not have his statement until he started to testify.

Normally, as a rule of thumb, the Treasury is opposed to all of these bills that we hear, and I was surprised and delighted, surprised to hear him say that he was in favor of Senator Denton's bill.

For the rest of you, I have read all of your statements, and obviously I am the only Senator here, and I think the only one who is going to be here today and in testimony you do not need to reread them to me.

They will all be in the record, and it would be helpful to me and helpful to you if you would not only abbreviate them, but give them orally, if you want, rather than just reading them.

I would like to call now on Mr. Doug Strain, chairman of the board of Electro Scientific Industries, and Mr. Richard H. Siemsen, corporate tax director for Emerson Electric, as a panel on S. 768 and S. 1472.

I might say that I have known Mr. Strain for a number of years, and he is one of Oregon's premier industrialists.

STATEMENT OF DOUGLAS C. STRAIN, CHAIRMAN OF THE BOARD, ELECTRO SCIENTIFIC INDUSTRIES, INC., OREG., REPRESENTING AMERICAN ELECTRONICS ASSOCIATION

Mr. STRAIN. Thank you, Chairman Packwood, for inviting me to appear before you and to testify today in support of Senator Denton's bill.

As my prepared remarks are already in the record, I will confine myself to what I can contribute most to here in our direct experience in our company with the problem of being denied an industrial development bond 2 years ago by the Port of Portland, because our research and development expenses were too high.

In our case, which is typical, at the time our company as is similar to the many companies in the American Electronics Association, which I also represent here today, some 1,500 companies there, we are a little above the median, we had about 300 people at that time when we applied for the bond, and even at that point over the 6-year period, our expenditures on research and development alone exceeded the $10 million bonding limit, so there was no money available to us.

We were attracted or promised an industrial development bond without being aware of this restriction, because the community

wished us to buy an old school building from them, which we proposed to remodel into a plant facility, with the aid of an industrial development bond.

Now, all of the paperwork went through, we were committed to the school board, and then we found we could not receive the bond, so we had to finance it with short-term financing at quite high rates that is costing us about $300,000 a year additional costs, which is about 25 percent of our net before-tax-profit this year, so it is a substantial decrease in our earnings, because we feel we were denied a bond as Senator Denton pointed out very clearly, on a technicality that really makes no economic sense if the purpose of industrial development bonds is to encourage employment.

Since that time we have grown to a company of 500 in the 2 year period, provided 200 more jobs. In our industry it costs about $50,000 investment for a job, and so that is an additional investment of $10 million, so an industrial development bond of $10 million does not go very far in our industry, and it really does help the very small companies, smaller indeed than we are at this time, so my appearance here today is sort of a labor of love, in that we would no longer qualify even if this bill is passed for an industrial development bond, because our general investment level now exceeds the $10 million over a 6-year period.

In the future if this issue comes up again, we of course would like to see that period of 6 years reduced. We think the bonding limit is now confined to extremely small companies, typically of from 100 to 200 people would be the only ones that we could see, even if this bill passed, that could make significant use of the bonds in high technology industry, so we think there are a lot of young companies in our association who could benefit by the passage of this particular bill, and we would certainly like to add our weight to the fact that we wished 2 years ago that this provision had been in effect, so that we too might have benefited at that time from the bill.

Thank you.

[The prepared statement of Mr. Strain follows:]

STATEMENT OF
Douglas C. Strain
Chairman of the Board
Electro Scientific Industries, Inc.

before the

Subcommittee on Taxation and Debt Management
of the

Committee on Finance
U.S. Senate
Washington, D.C.

September 25, 1981

SUMMARY

- Internal Revenue Service rulings discourage the use of tax exempt industrial revenue bonds by high technology companies engaged in research and development

- In view of recent tax incentives voted by Congress for research and development, AEA does not believe it is the intent of Congress to penalize companies heavily engaged in research and development.

- AEA strongly supports legislation directing that research and development costs be treated as expenses for purposes of industrial development bonds.

Mr. Chairman and Members of the Committee:

My name is Douglas C. Strain. I am Chairman of the Board of Electro Scientific Industries of Portland, Oregon.

I am here today representing the American Electronics Association. AEA is the largest trade organization for electronics companies in the U.S. The Association represents over 1,500 firms which employ more than one million American workers in 43 states. An additional 200 business and financial organizations participate in AEA as associate members. More than half of AEA's members are small, innovative growing businesses employing fewer than 200 persons. Our members manufacture electronic components, including semiconductors, computers, instruments, defense products and systems. Many supply products and services in the communications industries. More than three-quarters of the members are classified by the Small Business Administration as "small businesses" for purposes of P.L. 95-507 and other laws. While our membership is varied, the vast majority are commercial companies whose business with the Federal government comprises 10% to 15% of their total sales.

The purpose of my testimony is to document for this committee the unique difficulties faced by high technology companies in using tax-exempt industrial development bonds. Internal Revenue Service rulings unnecessarily discourage the use of such bonds by high technology companies heavily engaged in research and development. Under the "small issue" exemption for industrial development bonds the Internal Revenue Code permits a locality to issue tax exempt industrial revenue bonds to finance up to 10 million dollars in capital cost. For most tax purposes, a company's expenditures for research and

experimentation are treated as ordinary expenses, deductible in the year in which they are incurred. Congress mandated this treatment in Section 174 in order to encourage R&D and to avoid the audit and administrative problems involved in trying to distinguish between research "capital" costs and research "expenses." The IRS has ruled that research and development cost must be treated as capital expenditures over a six year period for the purpose of tax exempt bonding. This means that if any time in the six year period cumulative capital cost and research expenditures exceed a total of 10 million dollars, the bonds lose their tax exemption and revert to market interest rates. This happens even though the company has always treated research and development expenses as ordinary expenses deductible in the year in which they are incurred, and despite the fact that research expenditures themselves are not and cannot be financed with industrial development bonds proceeds. Such a ruling by IRS discriminates against companies with high R&D costs, even though these companies usually are the ones with the highest growth rates and provide the most job opportunities which IDB's were designed to create.

In the case of my company, Electro Scientific Industries, we had the opportunity to purchase an old school building which had been declared surplus by the local school board. We were told that an industrial development bond could be provided for the renovation of this old building into a new plant facility. On the basis of this assurance we gave our

commitment to the school board to purchase the property. Only when we made application for the tax exempt bond were we told that, because we spend between 1 1/2 and 2 million dollars a year on research and development to maintain our growth, we could not qualify for the bond. This occurs because over a six year period we would spend more than the bonding limit on R&D alone. Since the commitment already had been made to the school board, we had to obtain the necessary money at very high rates to provide temporary financing for the project and we are still searching for more permanent financing.

In view of the recent tax incentives voted by Congress to promote research and development, which AEA helped to formulate, we do not believe it is the intent of Congress to penalize companies such as ours and we would ask for the support of legislation to direct the IRS to treat research and development costs as expenses for the purposes of industrial development bond financing. We believe that the budgetary impact of this legislation would be small, particularly in view of the important encouragement it would give to research and development by small American businesses.

Senator PACKWOOD. We will now hear from Mr. Richard H. Siemsen.

STATEMENT OF RICHARD H. SIEMSEN, CORPORATE TAX DIRECTOR, EMERSON ELECTRIC, REPRESENTING NATIONAL COMMITTEE ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS, ACCOMPANIED BY RAMSAY D. POTTS, PARTNER, SHAW, PITTMAN, POTTS & TROWBRIDGE, WASHINGTON, D.C.

Mr. SIEMSEN. Mr. Chairman, my name is Richard H. Siemsen. I am corporate tax director of the Emerson Electric Co. in St. Louis.

I am here today representing the National Committee on Small Issue Industrial Development Bonds.

With me is Ramsay D. Potts, general counsel to the national committee, and senior partner in the lawfirm of Shaw, Pittman, Potts, & Trowbridge here in Washington.

I sincerely appreciate the opportunity to present our views on this key issue in support of Senate bill 768 and Senate bill 1472.

However, before addressing the committee on this specific issue, I would like to take a few moments to inform the committee of the background of the national committee's activities in relation to IDB's, where we developed a strong feeling that this is a key financing tool for capital formation and technological development.

We have worked with this issue for more than 3 years, and we now have a membership of over 95. The national committee has

testified at hearings in both the Senate and House, and has worked with individual Members of both bodies and staff.

During this process, we have analyzed and debated the pros and cons of this financing technique.

It is clear to us that IDB's are the only financing incentive which exists for investment in plant and equipment and the development of advanced technology.

Although recently overpublicized abuses may exist, they are diminimus in relation to the benefit provided in terms of job creation and jobs retained, investment in plant and equipment, the advancement of technology.

The abuses or charges thereof have not been channeled toward manufacturing facilities or technological development.

To the contrary, there has been strong vocal support.

R. & D. expenditures, which are an integral part of the U.S. competitive position in world markets, are currently encumbered by the IRS treatment of such expenditures, as capital expenditures for the $10 million limit test.

As illustrated in examples contained in my statement, many manufacturers, both large and small, are faced with undesirable alternatives.

As pointed out by the prior speaker, either they forego IDB financing of new and expanded facilities, or defer research and development of products and processes, or a combination of the foregoing.

Each of these results in a further deterioration of the competitive position of U.S. industry in world markets at a time when it is generally recognized that our competitive edge has evaporated.

The bills introduced by Senators Denton and Moynihan eliminate this dilemma, and therefore are endorsed by the national committee.

However, the current restrictions imposed on IDB's in a number of key areas must be addressed if this successful tool for promoting investment in plant and equipment is to be maintained and improved.

We are mindful of course of the White House statement issued last night in support of President Reagan's new tax cuts and spending proposals included an item which suggested the possible curtailment or restriction of tax exempt financing.

We would anticipate these proposals would be presented to this subcommittee, and to the full committee, for their consideration.

Senator PACKWOOD. It may account for why the Treasury supports your particular provision, because they are planning to get rid of the whole law anyway, so there is no harm in having this provision. [Laughter.]

Mr. SIEMSEN. Senator, we are hopeful that that is not their underlying objective, however, we would strongly suggest that in light of the useful tool, certainly in the manufacturing sector, I am speaking for Emerson Electric Co., we had utilized for that purpose, and with the R. & D. rule, we feel any such proposal should be analyzed as to its consequences.

Now is not the time.

Senator PACKWOOD. I can say this.

Senator Long knows this. In the Treasury Department, it is endemic to them to want to get rid of industrial revenue bonds. They do not like them. They are an anomaly in an otherwise neutral tax code, and so Republican or Democrat, consistently the tax reformers come and want to get rid of the revenue bonds.

I think you have the added factor at the moment with this administration, they are looking for all of the money they can get, and they are trying to cut $13 billion and raise $3 billion in taxes, and this is one place where they think they can get it, you can be sure it will come through this committee, and there will be long hearings on it, but the position of this Treasury Department on revenue bonds is not new to Treasury Departments. They have been opposed to them as long as I have been on this committee.

Mr. SIEMSEN. We are aware of that, Senator, and would like to suggest, that we are pleased that you, as you indicate, it will be considered by this committee, and analyzed very carefully, because we feel that the alleged gross revenue loss ignores the economic impetus provided by R. & D. industrial plant and equipment, financed by IDB's and that to take a short-term view is erroneous.

Senator PACKWOOD. I agree.

Senator Long?

Senator LONG. No questions.

Senator PACKWOOD. Dave?

Senator DURENBERGER. No questions.

Senator PACKWOOD. Gentlemen, thank you very much.

Doug, it is good to see you again.

Mr. STRAIN. Thank you.

[Prepared statement of Mr. Siemsen follows:]

TESTIMONY OF RICHARD H. SIEMSEN
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
SEPTEMBER 25, 1981

I. INTRODUCTION

Mr. Chairman and Members of the Committee, my name is Richard H. Siemsen. I am here today representing the National Committee on Small Issue Industrial Development Bonds. I am also Corporate Tax Director of Fmerson Electric Co. Accompanying me is Ramsay D. Potts, General Counsel to the National Committee and a senior partner of the Washington law firm of Shaw, Pittman, Potts & Trowbridge. I appreciate this opportunity to express the views of the National Committee in support of the proposed legislation affecting research and experimental (R&D) expenditures as they relate to small issue industrial bonds (or small issue IDBs).

The National Committee on Small Issue Industrial Development Bonds is a nonprofit membership organization dedicated to preserving and increasing the effectiveness of small issue industrial development bonds as mechanisms for capital formation and job creation. The National Committee presently has 95 members, principally corporations, but also state economic development organizations, investment bankers and other supporting individuals and groups. Attached as Exhibit A is a list of members of the National Committee.

Our committee has been actively involved in matters affecting small issue IDBs for the past several years. We believe that IDBs are an extremely important financing tool in encouraging capital formation, promoting the revitalization of American industries and stimulating the development of new products and technology. Our members have brought to our attention problems created by the rulings of the Internal Revenue Service (IRS) which severely restrict companies receiving IDB financing from pursuing R&D opportunities. In effect, the current treatment of R&D expenditures by the IRS discourages innovations brought about by research and development that are critical to improving America's competitive position in home markets and abroad.

We believe that S.768 and S.1472 would correct the current inconsistency in the tax law. Therefore, we strongly support these bills which would change the treatment of research and development expenditures as they affect the capital expenditure limitation on small issue IDBs.

As you know, the Internal Revenue Code permits the issuance of small issue IDBs for up to $10 million but requires that certain capital expenditures be included in determining the tax-exempt status of the bond. In order to maintain the tax-exempt status of the IDBs, capital expenditures plus the outstanding bonds may not exceed $10 million within the bond issuing jurisdiction for a six-year period

covering the three years prior and the three years subsequent to the issue date. If the capital expenditures plus the outstanding bonds exceed the $10 million limit, the bonds lose their tax-exempt status which results in higher interest costs and penalties. Therefore, it is essential that a company be in a position to monitor and control its capital expenditures within the period specified.

Although the Internal Revenue Code permits R&D expenditures to be either expensed or capitalized, the IRS has ruled that for purposes of small issue IDBs, R&D expenditures must be treated as capital expenditures. The IRS further requires that such R&D expenditures be allocated to manufacturing facilities which produce products which utilize such expenditures. This has the effect of allocating capital expenditures incurred at one facility to another facility which may have been financed with IDBs. As a result, a company using IDBs is placed in the ironical position of curtailing its research and development activities or risking the unexpected and somewhat uncontrollable allocation of such expenditures to an IDB facility with the consequent loss of the tax-exempt status.

This problem is of substantial concern to all industries; however, its impact is dramatized by the impact on high technology companies. These companies in the new growth areas, including, for example, firms involved in the microchip, biotechnology, and telecommunications industries, must develop and refine their own products and industrial processes. It is not unusual for even small high technology

firms to spend millions of dollars in research over a period of several years, thereby foreclosing the opportunity to use IDB financing for their facilities.

This situation has been compounded by the rulings of the IRS which hold that although R&D expenditures are treated as capital expenditures in computing the $10 million limitation, they are not eligible for financing from the proceeds of IDBs. The net effect of this inconsistent position is to discourage companies from engaging in research and development at a time when it is generally recognized that American industry (both small and large) has lost its competitive "edge" in world markets.

It is in the Nation's interest to encourage companies to engage in research and development. Therefore, we support passage of S.768 and S.1472 to correct this problem. The current treatment of R&D expenditures not only discriminates against firms involved in high technology fields, it is also counter-productive to the Nation's economic recovery because it discourages critical R&D investment. The proposed legislation would address both these problems. Moreover, this legislation is consistent with "The Economic Recovery Tax Act of 1981" recently enacted by Congress which encourages research and development activities.

Finally, the proposed legislation has the support of companies located in all regions of the country. We have been contacted by companies and state and local issuing authorities in several states, including New York, Oregon,

Georgia, Massachusetts and New Jersey, expressing support for S.768 and S.1472. These companies are in favor of the bills because the current treatment of R&D expenditures almost forces them to choose between an investment in technology or the requirements for financing production facilities, as the following examples illustrate:

- A California-based company which manufactures silicon, the basic component of semi-conductors for computers, recently financed a silicon manufacturing facility in another state with an $8 million IDB. The company is engaged in a highly competitive field and to remain competitive it must use the latest state of the art technology, equipment and processes. The research and development activities of this company have been severely restricted because current law requires that R&D expenditures be allocated to its new facility for the next three years under the capital expenditures test. This places the company in an inefficient operating mode and has deterred its development and refinement of new technology. Loss of the tax-exempt status of the bond (resulting in increased financing costs plus penalties) would be disastrous for the company.

- Another company had to sell its bond-financed facility when it realized that its R&D expenditures would be allocated to the facility and result in the loss of the tax-exempt status of the bond. The company, which is primarily engaged in manufacturing printing machines for cartons and corrugated boxes, had decided to expand into the graphics art work field by manufacturing computer and laser-fed printing equipment. This is another high technology field where research and development are critical. The company used two bonds totalling $4.5 million to acquire a new company and build a new facility in New York. Within a very short time, the capital expenditures from the bond-financed assets and the R&D expenditures were over $8 million. The parent company realized that with the projected allocated R&D expenditures, within less than a year, the total capital expenditures of the new company would exceed $10 million.

- Another company was unable to finance a new facility with a small issue IDB because of its R&D expenditures. The company planned to construct a medium-to-large scale manufacturing facility to produce computers. The land, building and some leased facilities cost approximately $6 million

and the company planned to acquire another $2 million in machinery and equipment. The company had no other capital expenditures within the issuing jurisdiction but had incurred $2 million in R&D expenditures in a distant jurisdiction which would be treated as allocable to the facility. Even so, the company was within the $10 million limit and the issuing authority had adopted a bond resolution. However, because the company anticipated a requirement to incur an additional $4 million in R&D expenditures in the next three years, it was forced to forego IDB financing. By proceeding with the bond-financing, the company would have been precluded from all further research and development activities which were critical to its competitive market position, or face the alternative of having the bond lose its tax-exempt status. The company, of course, had no choice but to forego this financing incentive.

II. DISCUSSION

In order to understand the need for this legislation, it is necessary to describe in some detail the complex provisions of Section 103(b)(6) of the Internal Revenue Code and the related Treasury regulations and rulings issued by the Internal Revenue Service.

87-056 O—81——6

A. General Principles Regarding the Issuance of IDBs. Generally, the interest on IDBs is included in the gross income of a bondholder unless a specific exemption under Section 103(b) of the Code applies. Section 103(b)(6)(A) of the Code provides an exemption in the case of certain small issues with a face amount of $1,000,000 or less. Section 103(b)(6)(D) of the Code provides that an issuer of IDBs may elect to issue bonds with an "aggregate face amount" not to exceed $10,000,000. For the purpose of determining the "aggregate face amount" of such issue, there must be taken into account the face amount of the bonds to be issued, the aggregate outstanding face amount of certain prior exempt small issues of the particular user, and the aggregate of certain capital expenditures referred to as "Section 103(b)(6)(D) Capital Expenditures". For example, if $9,000,000 face amount of IDBs are issued for the benefit of a particular user or users, the "Section 103(b)(6)(D) Capital Expenditures" of such user(s) cannot exceed $1,000,000 within the six-year period, or the IDBs will become taxable bonds.

The term "Section 103(b)(6)(D) Capital Expenditure" is defined in Treasury Regulation Section 1.103-10(b)(2)(ii) to include any expenditure if:

(a) The capital expenditure was financed other than out of the proceeds of an exempt issue;

(b) The capital expenditure was paid or incurred during the six-year period beginning three years prior to the date of issuance of the bonds and ending three years after such date;

(c) The principal user of the facility in connection with which the property resulting from the capital expenditure is used and the principal user of the facility financed by the proceeds of the issue in question is the same person or are two or more related persons.

(d) Both facilities referred to in (c) are located in the same incorporated municipality or in the same county (but not in any incorporated municipality); and

(e) The capital expenditure was properly chargeable to the capital account of any person or state or local governmental unit (whether or not such person is the principal user of the facility or a related person).

As can be seen from the foregoing definition, the concept of a "Section 103(b)(6)(D) Capital Expenditure" is an extremely broad concept encompassing expenditures made by any person at the facility financed with IDBs as well as expenditures made by any principal user of the facility at any other facility located in the jurisdiction of the issuer.

B. Application to Research and Experimental Expenditures. As was stated earlier, the interest on small issue IDBs is exempt from Federal income tax if the face amount of the bond plus the capital expenditures of the company for the preceding three years and the subsequent three years following the issue date do not exceed $10 million. Under present Internal Revenue Service rulings, firms engaged extensively in research and experimental expenditures are discouraged from using IDB-financing because such expendi-

tures have, pursuant to rulings issued by the IRS, been treated as capital expenditures. See Rev. Rul. 77-27, 1977-1 C.B.23; Rev. Rul. 77-253, 1977-2 C.B. 220. The IRS has taken the position that under Section 103(b)(6)(D), an expenditure is a capital expenditure if it is properly chargeable to the capital account of the company even though an elective provision which allows the expenditure to be deducted as a current expense is available under another section of the Code. R&D expenses fall within the scope of the preceding sentence by virtue of Section 174 of the Code.

Section 174 is an elective provision governing the treatment of R&D expenditures which allows the taxpayer to elect to treat certain R&D expenditures as current expenses and deduct them currently in the year in which they were incurred. Alternatively, under Section 174, the taxpayer may elect to amortize these expenditures over 60 months. Thus, Section 174 is an elective provision permitting the taxpayer to elect to deduct as current expenses expenditures which would otherwise be chargeable to a capital account. As such, these expenditures constitute capital expenditures under Section 103(b)(6)(D) for purposes of determining the $10 million limit. This is true even if the taxpayer has made the election to deduct the expenditures currently pursuant to Section 174.

This treatment of R&D expenditures as it exists under current law is especially harsh because a principal user of an IDB-financed facility must include as capital expendi-

tures all related R&D expenditures regardless of where such expenditures are paid or incurred or where such activities are conducted, if such activities relate to the products to be produced at the IDB-financed facility. Even R&D expenditures incurred outside the jurisdiction of the facility must be treated as capital expenditures for purposes of the capital expenditure limitation. At the same time a company and its counsel are faced with the IRS position that intangible expenditures are not financeable out of bond proceeds. This leaves them in a position where R&D expenditures for new product development are treated as capital expenditures for purposes of Section 103(B)(6)(D), but may not be treated as capital expenditures financeable out of bond proceeds.

A related area of concern involves the treatment of computer software expenses. The Internal Revenue Service has determined that computer software expenses may be capitalized in the same manner as research and development expenditures; accordingly, such expenses are subject to the same harsh treatment for purposes of the capital expenditure limitation. Enactment of S.768 or S.1472 should clarify that the computer software expenses are not capital expenditures for purposes of the capital expenditure limitation.

IV. CONCLUSION

The unfavorable tax treatment presently accorded R&D expenditures is an impediment to the financing of industrial activity and to the continuation of research and development

activities anywhere by a principal user of an IDB-financed facility. Current law makes it difficult, if not impossible, for U.S. companies to take advantage of IDB-financing, the result of which is counter-productive to both the recovery of the economy and the competitive interests of the United States in its own markets and abroad.

Therefore, we strongly support enactment of legislation removing research and development expenditures from the definition of capital expenditure for purposes of determining the tax-exempt status of small issue IDBs. Such legislation is not only complementary to other tax changes and incentives enacted this year to promote capital formation, it is a necessary step in helping the United States regain its competitive position in world markets.

EXHIBIT A

National Committee on Small Issue
Industrial Development Bonds

September 21, 1981

MEMBERS

ABS Industries, Inc.
Ajax Magnethermic Corporation
Akron Foundry
American Greetings Corporation
Anheuser-Busch, Inc.
Baldor Electric Company
Ball Corporation
George K. Baum & Co.
A. G. Becker Inc.
The Binswanger Co.
William Blair & Company
Boettcher & Company
Buffalo China, Inc.
Campbell Taggart, Inc.
Cargill Inc.
Carlisle Corp.
Chromalloy American Corp.
The Continental Group, Inc.
Copeland Corp.
Copperweld Corp.
Corning Glass Works
Dain Bosworth Corp.
The Dyson-Kissner-Moran Corporation
E. F. Hutton & Company Inc.
Eagle-Picher Industries, Inc.
A. G. Edwards & Sons, Inc.
Emerson Electric Co.
Essex Company
First Birmingham Securities Corp.
The First Boston Corporation
First Southwest Company
Franklin Electric Co.
Gantz Investment Company
Goldman, Sachs & Co.
Guild Craftsmen, Inc.
Hart Corporation
Hayes, Inc.
Health Care Fund
Hoover Universal, Inc.
The Hospital Corporation of America
J.C. Bradford & Co.
Joy Manufacturing Company
K-Mart Corporation
The Kroger Company
Langenthal Mills
The Marmon Group, Inc.
McDonald and Company
Hine Safety Appliances Co.

The Mortgage Corporation of America
Norris Industries, Inc.
Omark Industries
Plymouth Tube Co.
Portec, Inc.
Powell & Satterfield, Inc.
PPG Industries, Inc.
Ralston Purina Company
Renfrow Foundry
Robinson Foundry, Inc.
The Robinson-Humphrey Co.
South Haven Rubber Co.
Southwire Company
Stephens Inc.
Stifel, Nicolaus & Company Incorporated
Stihl Incorporated
The Synthetics Group
T. J. Raney & Sons, Inc.
UNIPAR Inc.
Vermont American Corp.
Wagner Division - McGraw-Edison Co.
Wal-Mart Stores, Inc.
Wetterau Inc.
Zappala & Company, Inc.
Wheat, First Securities, Inc.
White Consolidated Industries, Inc.

SUPPORTING ORGANIZATIONS AND INDIVIDUALS

Alaska Industrial Development Authority
Allegheny County Industrial Development Authority
Ballard, Spahr, Andrews & Ingersoll
Chapman & Cutler
Friday, Herschel H.
Gambrell, Russell and Forbes
Georgia Industrial Developers Association, Inc.
Hawkins, Delafield & Wood
Commonwealth of Kentucky, Development Finance Authority
State of Illinois, Department of Commerce & Community Affairs
State of Indiana, Department of Commerce
State of Maryland, Department of Economic and Community Development
North Carolina Industrial Developers Association
North, Haskell, Slaughter, Young & Lewis
Ohio Economic Development Council
Pennsylvania Association of Industrial Development Authorities
Southern Industrial Development Council
St. Louis County Industrial Development Authority
Tennessee Industrial Development Council
Commonwealth of Virginia, Division of Industrial Development
Wright, Lindsey & Jennings

Senator PACKWOOD. Let us now move on to S. 578 and S. 1276.

I might ask either Senator Long or Senator Durenberger, if they have a statement?

Senator LONG. I do not have any.

I thank you, Mr. Chairman.

Senator DURENBERGER. I would like to announce that a close friend of mine is here, Bevan Alvey. He is a lawyer, but is not being paid to be here. He came up with this panel, and he will testify on the same subject.

Mr. Chairman, I will ask my full statement be made a part of the record.

I would like to thank you for giving us an opportunity to speak on behalf of an urgent piece of corrective legislation.

The 1979 decision of the Supreme Court in the *Thor Power Tool* case has proven to be nothing less than catastrophic for many small businesses in this Nation, and yet it is not the Court that is to be blamed for that decision. It is the underlying law.

The ramifications of the *Thor Power Tool* decision are well known to us all and need little elaboration by me, but simply the decision mandated the businesses which continue to hold excess or obsolete inventory in the off chance that a customer may need it in later years to keep an old piece of machinery operating, must then value that inventory at his cost or at his sale price, whichever is lower, and businesses are now caught between the proverbial rock and a hard place when they try to be courteous and considerate to their customers by keeping parts on hand that have really outlived their usefulness for most people, so that the dealer must operate under a fair loss.

Mr. Chairman, the practical effect of the *Thor* decision is being felt by such people as a farmer who must junk a $20,000 tractor for lack of a $40 part, or an owner of a small construction company that cannot complete a major project because the parts do not exist to fix an 8-year old crane. I am pleased to be the author of a piece of legislation such as S. 1276, that would help persons with equity capital under $25 million from the impact of the *Thor* decision, and I appreciate your giving us the opportunity to speak on the bill today.

[The prepared statement of Senator Durenberger follows:]

STATEMENT BY SENATOR DAVE DURENBERGER

Mr. Chairman and Distinguished Senators. I would like to thank you for giving us this opportunity to speak on behalf of an urgent piece of corrective legislation now before Congress.

The 1979 decision of the Supreme Court in the *Thor Power Tool* case has proved to be nothing less than catastrophic for many small businesses in this nation. Yet it is not the Court that we should blame—it was only carrying out its constitutional task of interpreting the laws of Congress. Rather, it is the law that must be changed, and that is the reason for S. 1276.

The ramifications of the *Thor Power Tool* decision are well known to us all and need little elaboration. Put simply, the decision mandated that businesses which continue to hold excess or obsolete inventory in the off chance that a customer may need it in later years to keep an old piece of machinery operating, must then value that inventory at his cost or at its sales price, whichever is lower.

The effect of the decision has been to create a major new tax burden on the businesses that can least afford it. Businesses struggling under the immense burden of record high interest rates simply cannot absorb this latest financial blow.

The *Thor Power Tool* decision is particularly damaging because it affects businesses in an unfair and discriminatory manner. Businesses like the farm implement

dealers in my state of Minnesota, who try to serve their loyal customers by keeping parts on hand that can only be purchased once every several years, are particulary hard hit.

Before *Thor*, while it was not financially beneficial for dealers to keep parts on hand for many years, at least businesses did not suffer the major financial disincentive *Thor* has caused.

Businesses are now caught between the proverbial rock and hard place. If they try to be courteous and considerate to their customers by keeping parts on hand that have realy outlived their usefulness for most people, the dealers suffer an unfair loss of profits. If the dealers act in the manner best for the profitability of their business, they sell the outdated parts for scrap and force their customers to lose thousands of dollars worth of needlessly junked machinery.

Mr. Chairman, that is the level at which the full effects of the *Thor* decision are felt—it is the people who can afford it least who are being hurt the most: the farmer who must junk his twenty thousand dollar tractor for lack of a forty dollar part; the small construction company who cannot complete a major project because the parts don't exist to fix their eight year old crane; the small town hardware store owner who can't help his oldest and most loyal customers repair the machinery that puts food on their tables.

The inequities in the law illustrated by the *Thor Power Tool* decision fall full force on the very same small business and family farm owners who are struggling to survive the current economic times. The success and prosperity of our nation depend upon these people—and we owe it to them to remove this punitive and unfair tax burden.

S. 1276 would do just that for businesses with equity capital under $25 million. This bill provides that after a piece of inventory is held for 12 months, it is then regarded as excess or obsolete. Thereafter, that piece of inventory can be written off at a third of its value per year for the next three years. In essence, then, S. 1276 allows businesses to write off excess or obsolete inventory over a period of four years.

To conclude, Mr. Chairman, let me stress again how badly this piece of legislation is needed. Businesses most affected by the *Thor* decision just do not have a lot of time to wait. They need this legislation, and they need it now. I am confident this committee will give S. 1276 the swift and favorable action it deserves.

Senator PACKWOOD. Pat, do you have any opening statement on this bill?

Senator MOYNIHAN. No. Thank you very much.

Senator PACKWOOD. Gentlemen, let's have Mr. Arthur Dempsey, Mr. Leonard Bergan, Mr. William Galbraith, Mr. Frank E. McCarthy, and Mr. William D. Barth from the first panel.

If you abbreviate your statements, and they will in full be placed in the record, and I can especially assure you on this topic, this is not one that is foreign to this committee.

Senator Moynihan and Senator Durenberger have kept us well advised of this subject.

Mr. Dempsey is from Rickreall, Oreg. He said when he came to testify today, that half the town was gone, and knowing Rickreall, it is very close to an accurate description.

Mr. Dempsey, do you want to start?

STATEMENT OF ARTHUR DEMPSEY, PRESIDENT, RICKREALL FARM SUPPLY, INC., RICKREALL, OREG., AND FIRST VICE PRESIDENT OF NATIONAL FARM & POWER EQUIPMENT DEALERS ASSOCIATION, ACCOMPANIED BY LEONARD BERGAN, PRESIDENT, CROOKSTON IMPLEMENT CO., INC., CROOKSTON, MINN., AND SECOND VICE PRESIDENT AND LEGISLATIVE COMMITTEE CHAIRMAN OF THE ASSOCIATION; AND WILLIAM GALBRAITH, EXECUTIVE VICE PRESIDENT OF THE ASSOCIATION

Mr. DEMPSEY. Thank you, Mr. Chairman.

I appear here today as first vice president of the National Farm & Power Equipment Dealers Association, which has its headquarters in St. Louis.

With me is our second vice-president, Leonard Bergan, and our executive vice president, Mr. William Galbraith.

I am going to try to ad lib our presentation because we have been debating various theories about the *Thor Power* decision and we could spend all day today and part of the weekend here on the subject.

We represent basically 10,000 equipment dealers throughout the 50 States of the United States, and we are here today to lend our support to S. 1276 introduced by Senators Durenberger and Melcher.

Now, the *Thor Power Tool Co.* case as decided by the Supreme Court raised chaos and confusion among the 10,000 dealers that we represent.

Over the past year there has been considerable discussion about its application to a retail dealer. I might add that this word "retail" is a bit confusing too, because we have not been classified as retailers by the Federal Government, we have been classified as wholesalers.

In any event, we are not manufacturers. We are retail dealers. We deal with a manufactured product which we sell to a customer. The theory we have been operating under, and which has been approved, is standardization in our business and industry.

As you are probably aware, in the State of Oregon we spent thousands of dollars establishing the value of a used tractor in a particular year, and the decision after 2 years of study was made that the w[illegible]ve is established at time of sale. Now, we are facing the same problem with valuation of parts basically.

We receive a new machine from our manufacturers, and along with that comes a basic package of parts that we should buy to service this particular product.

Maybe in some areas these parts would be applicable to this machine, but this is not necessarily true in all areas.

Thus, the machine is in a way contributory to receiving the parts package, which can cost all the way from $2,000 to $10,000. Quite often these parts are not salable in our area the first year these sophisticated machines are introduced, because they probably have been field tested not quite as long as they should be. So our parts problems could be in other areas of the machine. In many cases then, we have thousands of dollars of parts which we paid for, and have invested in inventory.

We find that they are of no value to us at this time, but down the road they could possibly be, so this is where we get into surplus parts, and this is our problem.

Senator PACKWOOD. Well, to use an example, you have about 100 1960 Chevrolet carburetors on hand, and you are likely to sell 10 or 15 maybe over the year, maybe not, so what do you do, throw the rest of them away, or what do you do with them in order to get a deduction?

Mr. DEMPSEY. A classic example is what happened to us in the early 1950's. We had a combine that had a transmission failure.

We would sell 50 to 75 transmissions every year, but about 5 years later, all of a sudden, no more sales of transmissions parts, and we have probably $14,000 to $15,000 in transmission parts with no one to buy them.

Senator PACKWOOD. Yes.

You phrase it very well.

[The prepared statement of Mr. Dempsey follows:]

National Farm and Power Equipment Dealers Association
STATEMENT BEFORE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

FINANCE COMMITTEE
UNITED STATES SENATE

September 25, 1981

Mr. Chairman and Members of the Subcommittee,

My name is Arthur Dempsey and I am the First Vice-President of the National Farm and Power Equipment Dealers Association. With me is our Second Vice-President, Leonard Bergan and our Executive Vice-President, Mr. William Galbraith.

Our organization represents the more than 10,000 dealers throughout the United States who sell and service farm, construction, and industrial equipment for all of the major manufacturers with which you are familiar and the numerous smaller manufacturers of which you may not be aware.

We wish to convey to you today our vigorous and unanimous support for S.1276 introduced by Senators Durenberger and Melcher and their co-sponsors. This bill would remedy many of the inequities under present law which have been highlighted by the decision of the United States Supreme Court in Thor Power Tool Co., v. Commissioner of Internal Revenue, 439 U.S. 522 (1979) which concerns excess or obsolete inventory. It is not our desire to obtain a special tax benefit or to deprive th Federal Government of needed revenues. In fact it is our belief, based upon information provided by our

advisors, that if businesses adopt the system outlined in S.1276 there will actually be an increase in revenues since they will be writing down inventories on a much more gradual basis than at the present time.

The bill, as you know, provides that excess or obsolete inventory can be written off in equal installments over a three year period. It also provides a very clear definition of excess or obsolete inventory which any businessman can understand regardless of the size of his business or the sophistication of his accounting system. Since the bill delays the imposition of the revenue procedure and revenue ruling designed to enforce the Thor Power decision, the businessman, in essence, has a clean slate from which to work once he adopts the system provided by S.1276.

In order to understand why we are desperately in need of this legislation and why it is the most important issue facing our organization, it is necessary to give a brief explanation of the relationship which exists among the manufacturer, the dealer, and the customer most of whom are farmers. The manufacturer naturally desires to maximize sales of equipment and parts. As a result, a dealer is frequently required to buy a package which includes not only an expensive piece of new equipment but also several thousand dollars of parts for that piece of equipment.

The competition among manufacturers and the customers' desire for more productive equipment result in the continuous introduction

of different pieces of equipment and ever-changing models. For this reason, neither the manufacturer nor the dealer can forecast with a great deal of accuracy which parts will need replacement.

The dealer is thus frequently in possession of numerous parts for which there is little demand. He has two alternatives. The first depends upon the manufacturer's repurchase program. Most manufacturers will buy back a percentage of a dealer's parts but this is usually at a price below what the dealer paid. And manufacturers will rarely repurchase a significant amount of excess parts. The second choice is to sell the parts for scrap which results in a loss of the difference between the cost of the parts from the manufacturer and the current scrap value of metal.

While the dealer suffers either way, the customer, in this case the farmer, experiences the real loss. The most extreme case involves the older piece of equipment for which parts are no longer manufactured. The owner of such a piece of equipment is faced with spending an enormous amount of money to have a part made by a machine shop or abandoning the piece of equipment entirely. In these days of inflation, and as a matter of good business practice, it is natural to use a piece of equipment for as long as possible. The dealer desires to contribute to this practice by having the parts necessary to operate the older machinery.

The second and much more common experience of a customer is failure of a part on a piece of equipment which is only three or four years old during the planting or harvesting season when it is critically needed. If the part is not on hand, the delay in obtaining it means significant financial loss from late plantings or lost crops.

Even so, the cost of the part is exorbitant (frequently several times its ordinary cost) since it involves special handling and air freight charges to assure immediate installation. Again, the farmer suffers and of course in the end we all lose as a result of the additional costs which are included in the ever-increasing price of food.

Thus, a dealer will normally maintain a sufficient inventory to protect his customers, both those with older machinery and those with the new pieces of equipment. It is unrealistic, however, to demand that for tax purposes a dealer regard a part at its original cost or at the retail price when the part has been held for a considerable period of time with little or no hope of being sold. Such a requirement is contrary to normal business practice. Nevertheless, that is precisely what is demanded under the law today as it is interpreted by the Internal Revenue Service with the approval of the United States Supreme Court.

The departure of the Internal Revenue Service proclamation from the realities of business practice is recognized by the U.S. Supreme Court in Thor. The Court noted that Generally Accepted Principles of accounting demand that inventory be reduced in value to account for obsolescence. In other words, failure to write down inventories will present a false financial picture. A businessman is thus told by his accountant that he has suffered a loss through devaluation of inventory. For decades, and almost universally, businessmen have taken this loss into account in determining tax liability.

The Internal Revenue Service also recognized the fact that its position was out of step with the practice of innumerable tax advisors who normally suggest, or at least condone, the deduction of an inventory loss each year. As a result, the IRS directed that all prior deductions for existing inventory be restored to income and that the resulting tax be paid over a period of ten years. It is this ten year grace period which evidences the IRS recognition of the enormous problems created by the Thor decision.

Some would argue that in view of Treasury's largess in permitting a lengthy repayment period for taxes legally due immediately, the business community is demonstrating greed in seeking even greater relief. However, when one considers the number of bankruptcies among small businesses in the last few years, the marginal profits of those

which have survived and the bleak forecast for many months to come, one can only ask where the money to pay any additional tax on wholly fabricated income is to be obtained.

There is an even more compelling reason for the relief being sought under S.1276. Most small businesses have not been advised that they should make the adjustments required by IRS. Few, if any, would have the expertise to make such an adjustment even if they were aware of the requirements. Most important, however, is the fact that many have been advised erroneously that the Thor decision and the resulting IRS actions do not apply to businesses unless they engage in manufacturing. We can document such advice to many of our members. One of the major advantages of this bill is the simplicity and certainty which it provides not only to the taxpayer but also to the Treasury. No longer will a businessman base an inventory deduction on a subjective determination as to the loss in value through obsolescence. The formula is rigid and does not permit guesswork or deviation. Moreover, the taxpayer is assured that the deduction will not be questioned by a Revenue Agent.

More importantly from the viewpoint of the Internal Revenue Service is an end to the manipulation of the inventory deduction to reduce taxable income. It is no secret that some businessmen will take large inventory deductions to reduce taxable income

and small deductions in lean years when they are not needed. However, if this new system is adopted, the taxpayer is obligated to follow it thereafter until such time as the Secretary of the Treasury agrees to a change in method.

Thus, we are not seeking to legitimize the prior practice. Rather, we support an even-handed solution to a problem which has perplexed both taxpayer and tax collector for many years. The bill will not only prevent past abuse, it will most certainly improve revenues. The gradual deduction of inventory losses over three years (actually four in view of the 12 month holding period) will reduce the deduction which might otherwise by available in a single year.

In conclusion, Mr. Chairman, we wish to impress the seriousness of this matter upon the subcommittee. Thousands of businessmen are unwittingly filing returns in violation of the Thor decision. The answer is not to attempt compliance through the audit procedures. Such an approach is hopeless. We ask that this subcommittee not seek to impose penalties but to enact an expeditious, fair solution.

Thank you for giving us the opportunity to appear and present our views. If there are any questions we would be most happy to attempt to provide answers.

Senator PACKWOOD. Mr. McCarthy?

STATEMENT OF FRANK E. McCARTHY, EXECUTIVE VICE PRESIDENT, NATIONAL AUTOMOBILE DEALERS ASSOCIATION, ACCOMPANIED BY JOHN J. FERRON, EXECUTIVE DIRECTOR OF RESEARCH AND DEALER OPERATIONS, NATIONAL AUTOMOBILE DEALERS ASSOCIATION

Mr. MCCARTHY. Thank you very much, Mr. Chairman.

My name is Frank E. McCarthy. I am the executive vice president of the National Automobile Dealers Association, and with me is Mr. John J. Ferron, on my left, who is the executive director of research and dealership operations group.

I certainly will heed your suggestion to summarize.

First of all, on page 2, a story we feel we must tell in short form, is that high interest rates have really been killing both automobile and truck dealers.

The costs they are now paying on inventory of automobiles, trucks, and parts is 1 percent over prime, which today would make it 20½ points, and then on the other side of the coin, the price that the customer must pay when buying a truck or buying a car with financing it is in the neighborhood of 17 percent.

These high interest rates on both sides of this coin have really reduced sales, have resulted in over 2,500 dealers going out of business in the last 2 years and have resulted in 125,000 actual dealership employees losing their jobs.

We feel that this inventory reform hearing this morning is timely and extremely important to dealers, because in a period when their new vehicle sales have dropped off substantially, they must do everything they can to improve their cash flow in a legitimate way.

On page 3, for example, an average dealer carries about $500,000 in inventory on vehicles and approximately $100,000 in parts and accessory inventory.

I might add that truck dealers' inventories are higher. They range more in the neighborhood of $1 million, because some of these heavy duty tractors run in the neighborhood of over $50,000 per tractor, and the parts are also proportionately higher.

We would very much like to comment briefly on these inventory reform measures, and we recognize that the reform requires not one single approach, but certainly a multifaceted solution that provides both short- and long-term relief.

First of all, dealers definitely need a legislated objective percentage writedown for excess inventory items.

This is the concept contained in S. 1276 for items of inventory over 12 months, and we believe that this approach more directly addresses the needs of our members than S. 578.

However, S. 578 does provide some relief. The reason we stress the legislated percentage writedown is that the dealers have in stock many thousands of parts. The larger dealers maybe have as many as 10,000 to 15,000. The smaller dealers maybe 5,000 to 7,000. It is almost impossible for dealers, being small business people, with limited number of personnel in the parts department, to have all of the inventory clerks and the accountants necessary to age the parts and things like that, so a clearcut percentage writedown

is definitely to their advantage, and about the only way the system would work.

We also are very much in favor of the LIFO reforms.

Very quickly, the LIFO conformity is critical for dealers in a special way because the manufacturers require all dealers to file a financial statement monthly with the manufacturer, so they have prescribed financial forms, they must comply with, and many times that last statement might throw them out of conformity with LIFO on a technical basis.

There are many cases pending on this, and this would cure it in a very effective way, it would be very important.

We also very strongly support the 10-year provision as far as spreading the penalty tax for the obvious reason that many dealers now would like to opt to go on LIFO but they need 10 years to spread this additional cost burden.

One final measure I would like to mention quickly, but it is of critical importance to our truck dealers, has to do with the Federal excise tax on trucks and truck parts. Currently when a truck costs $50,000, the excise tax on the truck is 10 percent, $5,000, If a dealer has 20 trucks in stock, that amounts to a tax of $100,000, and he actually must borrow money to finance that tax, which seems ridiculous to us.

Our proposal is to postpone the collection of the excise tax to the point of retail sale so that the dealer does not have to finance the tax on those trucks he has in inventory.

That quickly summarizes what we think are the most important aspects of our statement, and, Mr. Chairman, we would appreciate it if the full statement would be included in the record.

We would be happy to answer any questions at the appropriate time.

Senator PACKWOOD. Your full statement as will all of the statements be in the record.

Mr. MCCARTHY. Thank you.

[Prepared statement of Mr. McCarthy follows:]

A RECORD STATEMENT
OF THE
NATIONAL AUTOMOBILE DEALERS ASSOCIATION

SUBMITTED TO THE

SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

PRESENTED BY:
MR. FRANK E. McCARTHY
EXECUTIVE VICE PRESIDENT

WASHINGTON, D. C.
SEPTEMBER 25, 1981

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. MY NAME IS FRANK E. MCCARTHY, EXECUTIVE VICE PRESIDENT OF THE NATIONAL AUTOMOBILE DEALERS ASSOCIATION. WITH ME TODAY IS JOHN J. FERRON, EXECUTIVE DIRECTOR OF NADA'S RESEARCH AND DEALERSHIP OPERATIONS GROUP.

NADA IS A TRADE ASSOCIATION REPRESENTING APPROXIMATELY 20,000 NEW CAR AND TRUCK FRANCHISED DEALERS. WE APPRECIATE AND WELCOME THE OPPORTUNITY TO APPEAR BEFORE THE SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT. TODAY WE WILL BRIEFLY TESTIFY ON INVENTORY REFORM ISSUES AFFECTING THE SMALL BUSINESS AUTOMOBILE AND TRUCK DEALERS.

IN OUR REMARKS WE WILL HIGHLIGHT THE FOLLOWING INVENTORY REFORM MEASURES WHICH WILL HELP OUR MEMBERS. EACH IS RELATED TO THE TREATMENT OF INVENTORIES AND THE COST OF CARRYING INVENTORIES, HENCE GERMANE TO ANY DISCUSSIONS OF BILLS SUCH AS S. 578 AND S. 1276.

FIRST, DEALERS NEED A LEGISLATED OBJECTIVE PERCENTAGE WRITEDOWN OF EXCESS INVENTORIES WHICH RECOGNIZES THE BUSINESS PRACTICALITIES OF SMALL BUSINESSES.

SECOND, LAST IN-FIRST OUT (LIFO) ACCOUNTING PROCEDURES MUST BE DRAMATICALLY SIMPLIFIED TO INCREASE ITS' USE BY OUR MEMBERS.

THIRD, A SPECIFIC REMEDY IS AVAILABLE FOR OUR TRUCK DEALERS WHO HAVE TO FINANCE FEDERAL EXCISE TAXES ON TRUCKS, PARTS AND ACCESSORIES.

PRIOR TO DISCUSSING EACH POINT IN ORDER, A GENERAL OBSERVATION MUST BE MADE. THE NEED FOR INVENTORY REFORM HAS ALWAYS BEEN DESIRABLE FOR DEALERS AND OTHER SMALL BUSINESSMEN. NOW IT IS VITAL! THIS EXTREMELY TECHNICAL COMPLEX ISSUE OF TREATMENT OF INVENTORIES IS CRITICAL TO THE SURVIVAL OF HUNDREDS OF DEALERSHIPS BECAUSE OF THE HIGH AND VOLATILE COSTS OF MONEY.

THE INTEREST RATES HAVE AGGRAVATED THE DISPARITIES AND INEQUITIES BETWEEN LARGE AND SMALL BUSINESSES. THE NORMAL COMPLEXITIES OF TAX LAW COUPLED WITH SALES SLOWDOWNS AND AN EMPHASIS ON CAPITAL FORMATION HAVE LEFT OUR MEMBERS IN A DESPERATE SITUATION.

THE ECONOMY AND THE NATURE OF DEALERSHIPS DRAMATICALLY SUPPORTS OUR RATIONALE. WITH CAR AND TRUCK DEALERS LOSING MONEY, INVENTORY REFORM IS THE MOST EFFECTIVE WAY TO INCREASE THEIR COLLECTIVE CASH FLOW.

THE PROBLEMS OF THE AUTOMOTIVE INDUSTRY IN THIS NATION ARE WELL KNOWN AND DOCUMENTED. LESS UNDERSTOOD IS THE CUMULATIVE EFFECT HIGH AND VOLATILE INTEREST RATES, DEPRESSED VEHICLE SALES AND CRUSHING INVENTORIES HAVE HAD UPON OUR MEMBERS. IN THE PAST TWO YEARS OVER 2,500 DEALERS HAVE PERMANENTLY CLOSED THEIR DOORS. OVER 125,000 DEALERSHIP EMPLOYEES HAVE LOST THEIR JOBS. THE DAYS SUPPLY OF DOMESTIC CARS AND TRUCKS, NOW OVER 75 DAYS, INDICATES THAT WHILE SALES SEEM BETTER COMPARED TO THE CORRESPONDING PERIOD LAST YEAR, THE INCREASE IN PURELY THE RESULT OF PRICE REBATES.

THE NATURE OF CAR AND TRUCK DEALERSHIPS ALSO SPECIFICALLY AGRUES FOR INVENTORY RELIEF. FOR EXAMPLE, OUR TYPICAL MEMBER HAS ABOUT $5.0 MILLION IN TOTAL DEALERSHIP SALES. THIS MEANS THAT THE AVERAGE DEALER CARRIES ABOUT $500,000 INVENTORY IN VEHICLES AND $100,000 IN PARTS AND ACCESSORIES. TRUCK DEALERS QUITE NATURALLY, WITH HEAVY TRUCK PRICES WELL ABOVE $50,000 PER UNIT, EASILY RANGE ABOVE $1 MILLION IN VEHICLE AND PARTS INVENTORIES. WITH THE CURRENT COST OF FINANCING ABOVE 20% THE INVENTORY BURDEN REPRESENTS A SEVERE CASH DRAIN.

THE SIMPLE CONCLUSION IS THAT SOMETHING CLEARLY NEEDS TO BE DONE. IT IS ALSO CLEAR THAT THE ISSUE OF INVENTORY REFORM REQUIRES NOT ONE SINGLE APPROACH BUT MULTI-FACETED SOLUTIONS THAT PROVIDE SHORT AND LONG TERM RELIEF.

NOW, BRIEFLY, I WILL COVER EACH POINT IN TURN.

DEALERS NEED A LEGISLATED, OBJECTIVE, PERCENTAGE WRITEDOWNS FOR EXCESS INVENTORY ITEMS. THIS IS THE CONCEPT CONTAINED IN S. 1276 FOR ITEMS IN INVENTORY OVER 12 MONTHS. NADA BELIEVES THAT THIS APPROACH MORE DIRECTLY ADDRESSES THE NEEDS OF OUR MEMBERS THAN S. 578. HOWEVER, S. 578 WOULD BE A DEFINITE IMPROVEMENT OVER THE CURRENT SITUATION FOR THE 4 OUT OF 5 DEALERS WHO HAVE NOT ELECTED LIFO. A SURVEY BY NADA INDICATED THAT A TYPICAL DEALERSHIP HAS 47% OF THE TOTAL PART LINE ITEMS HELD IN INVENTORY UNSOLD IN THE PREVIOUS 12 MONTHS. THIS IS NOT BECAUSE OF POOR MANAGEMENT ALONE, ALTHOUGH IT CERTAINLY CONTRIBUTES. DEALERS HAVE TO STOCK MANY PARTS FOR AN EXTENDED PERIOD OF TIME BECAUSE OF CUSTOMER SERVICE CON-

SIDERATIONS AS WELL AS TERMS IN FRANCHISE AGREEMENTS WITH THEIR MANUFACTURERS.

A TYPICAL DEALER MAY STOCK 15,000 PART LINE ITEMS. AS DUELLING OF IMPORT AND DOMESTIC CAR AND TRUCK DEALERS CONTINUES, THE AVERAGE DEALER INVENTORY LINE ITEM IN STOCK WILL INCREASE ALSO.

BOTH S. 1276 AND S. 578 WILL ALLEVIATE THE TOTALLY IMPRACTICAL SITUATION OF BEING COMPLETELY AT THE MERCY OF IRS DISCRETION ON THE TREATMENT OF EXCESS INVENTORY.

NADA SUPPORTS THE PROVISIONS IN S. 578 DEALING WITH LIFO CONFORMITY REQUIREMENTS REPEAL AND THE 10 YEAR SPREAD PERMITTED FOR ANY INCREASES IN INVENTORY VALUE REQUIRED FOR ADOPTION OF THE LIFO METHOD. THE RECENT CHANGE IN THE ECONOMIC RECOVERY TAX ACT OF 1981 PERMITTING A 3 YEAR SPREAD OF THE "PENALTY TAX" ASSOCIATED WITH THE RESTATEMENT OF BEGINNING LIFO INVENTORIES TO COST IS OF SOME HELP. BUT CLEARLY THE 10 YEAR PROVISION WOULD NEARLY ELIMINATE THE INITIAL PENALTY AND THUS INCREASE LIFO ELECTIONS BY OUR MEMBERS.

NADA, AS WELL AS OTHERS, IS UNCLEAR ABOUT THE TREATMENT OF ANY TAXPAYER WHO IS CURRENTLY WITHIN THE 10 YEAR SPREAD ALLOWED BY THE THOR RESTORATION UNDER REVENUE PROCEDURE 80-5 AND WHO NOW ELECTS LIFO. SURELY THE EXISTING 10 YEAR SPREAD SHOULD NOT BE JEOPARDIZED BY THE SHORTER 3 YEAR ONE JUST ENACTED.

ANOTHER LIFO PROVISION SHOULD BE MENTIONED BRIEFLY. NADA BELIEVES THAT THE LIFO RECAPTURE PROVISIONS OF THE WINDFALL PROFITS ACT [403 (B)] SHOULD BE REPEALED. CURRENTLY,

IF A BUSINESS IS LIQUIDATED PURSUANT TO A PLAN OF LIQUIDATION ADOPTED BEFORE JANUARY 1, 1982, THE LIFO RESERVE WILL MOST LIKELY NOT BE TAKEN INTO INCOME. THIS IS BECAUSE THE IRS, HAVING BEEN PREVIOUSLY REQUESTED TO REVIEW THIS FACT SITUATION, HELD THAT "THE 'TAX BENEFIT RULE' DOES NOT APPLY TO THE BULK SALE OF LIFO INVENTORY PURSUANT TO A PLAN OF LIQUIDATION UNDER SECTION 337 OF THE CODE" (REVENUE RULING 74-431, CB 74-36,9).

NOW, HOWEVER, UNDER THAT RIDER TO THE WINDFALL PROFITS TAX ACT (WHICH WAS NOT DEBATED NOR APPARENTLY SUPPOSED TO COVER OTHER THAN OIL COMPANIES) A PLAN OF LIQUIDATION ADOPTED AFTER DECEMBER 31, 1981, WILL HAVE THE LIFO RESERVE TAKEN INTO INCOME.

NOTHING HAS CHANGED BUT EVERYTHING IS DIFFERENT!

ALL THIS WHILE CAR AND TRUCK DEALERS IN INCREASING NUMBERS ARE TRYING TO ELECT LIFO AS A PARTIAL SHELTER FROM THE CUMULATIVE, SEVERE AND CONTINUING EFFECTS OF INFLATION AND HIGH INTEREST RATES. SINCE CONGRESS CAN REVERSE OR DELAY THIS PROVISION'S IMPACT, WE STRONGLY RECOMMEND THAT IT DO SO AS PART OF AN OVERALL SIMPLIFICATION OF LIFO.

ONE FINAL INVENTORY MEASURE WILL BE OF SPECIFIC AID AND ASSISTANCE TO OUR TRUCK DEALERS. CURRENTLY, THEY MUST PAY INVENTORY FINANCING CHARGES OF ABOVE 20% ON THE FEDERAL EXCISE TAX (FET) ON TRUCKS, TRAILERS AND PARTS.

THE 10% FET LEVIED AGAINST TRUCKS AND 8% TAX ON PARTS IS PART OF THE FUNDING OF THE HIGHWAY TRUST FUND.

WE PROPOSE TO CHANGE THE POINT OF COLLECTION OF THE TAX FROM THE WHOLESALE LEVEL TO THE RETAIL SALE OF THE TRUCK OR PART. THIS CAN BE DONE WITH NO ADVERSE EFFECT UPON THE HIGHWAY TRUST FUND. IN THE PROCESS THIS TAX, WHICH AMOUNTS TO $5,000 TO $7,000 PER TRUCK, WOULD NO LONGER HAVE TO BE FINANCED BY THE TRUCK DEALER. THIS WOULD SAVE MILLIONS OF DOLLARS IN 1981 BECAUSE OF LESSENED TAX BILLS, INVENTORY TAXES AND INSURANCE COSTS.

THIS TECHNICAL CHANGE IN THE EXISTING LAW IS THE THRUST OF ANOTHER INVENTORY REFORM BILL UNDER THIS COMM[illegible]EE'S JURISDICTION, S. 1320 INTRODUCED LAST SPRING.

WITH INTEREST RATES DEVASTATING TRUCK SALES AND DIMINISHING NET WORKING CAPITAL IN TRUCK DEALERSHIPS, THIS MEASURE WOULD PROVIDE IMMEDIATE RELIEF WITHOUT ALTERING THE AMOUNT OF REVENUES CURRENTLY BEING PRODUCED BY THE TAX.

IN SUMMARY, NADA KNOWS ITS DEALERS ARE SHOULDERING MORE THAN THEIR FAIR SHARE OF THE FIGHT AGAINST INFLATION. WE REPRESENT AN INTEREST SENSITIVE, BUT VITAL SEGMENT OF THE ECONOMY. WE NEED RELIEF. WE NEED INVENTORY REFORM AND WE NEED ENACTMENT OF MEASURES SUCH AS THE BILLS WE HAVE SUPPORTED THIS MORNING.

MR. CHAIRMAN, THANK YOU FOR YOUR TIME. WE WILL ANSWER ANY QUESTIONS YOU HAVE ABOUT OUR SUGGESTIONS.

THANK YOU.

Senator PACKWOOD. Mr. Barth?

STATEMENT OF WILLIAM D. BARTH, PARTNER, ARTHUR ANDERSEN & CO., REPRESENTING THE SMALL BUSINESS LEGISLATIVE COUNCIL OF WASHINGTON, D.C.

Mr. BARTH. Mr. Chairman, members of the committee, my name is William Barth. I am the director of the small business practice of Arthur Andersen & Co., and I am here today representing the Small Business Legislative Council.

Many small businesses have historically established inventory reserves for slow paying excess inventory, but it is unfortunate indeed that the present tax rules, which prohibit recognition of these writedowns, encourage bad business practices.

Tax regulations which run contrary to good business practices are simply bad tax regulations.

In my written testimony I gave the example of a client company of ours which badly needed the cash flow from a writedown of obsolete or excess inventory as of last year end.

As their consultants, we helped them solve the problem. We called for a dump truck, loaded $180,000 of precision instruments in the truck and took them to the Chicago city dump.

The company was hesitant to dispose of the inventory, because of the possibility that these subassemblies could be used in future products.

Yet the result came about because of our wasteful tax rules, as you have already heard.

In my written testimony I have cited the Committee on Taxation of the American Institute of CPA's, which supports the position that I am taking today.

Similarly the Small Business Legislative Council actively supports legislation to permit a valid writedown of inventory and thus avoid the destruction of useable property.

It notes that the cost to our economy arising from the shortened lives of thousands of items whether they be used in households or in factories, is staggering.

As I was sitting here, it struck me all of a sudden that we are not talking about a tax deduction that will never be realized.

This will be realized by all companies at some point in time. It may be 5 years, 10 years, 15, or 20 years out, that events will transpire which will make the deduction realizable.

What we are speaking of is an immediate prepayment of tax, and as accountants we classify it as prepaid income taxes.

Few of us like to pay taxes. I have not met anyone who does. Certainly we dislike prepaying taxes, and that is the result of the present regulations.

The inconsistency which exists between income tax regulations and sound business practices encourages taxpayer responses which do not make sense from a business point of view.

The small business community, which is sometimes referred to as the endangered species of our free enterprise system, urges the passage of legislation such as that proposed by Senators Moynihan and Durenberger.

Thank you very much.

Senator PACKWOOD. Thank you.

[The prepared statement of Mr. Barth follows:]

STATEMENT OF WILLIAM D. BARTH
ON BEHALF OF THE SMALL BUSINESS LEGISLATIVE COUNCIL
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE
HOLDING HEARINGS ON EXCESS INVENTORY ACCOUNTING
AND INDUSTRIAL DEVELOPMENT BONDS
SEPTEMBER 25, 1981

Mr. Chairman and Members of the Committee:

My name is William D. Barth. I am Director of Small Business Practice of Arthur Andersen & Co. I am appearing today on behalf of the Small Business Legislative Council (SBLC), an organization of 72 small business and trade associations representing over 4 million U.S. business enterprises nationwide.

My comments today will address the legislation covered by part of S. 578 and S. 1276, introduced by Senators Moynihan and Durenberger, respectively. I believe this legislation is important to the small business community, and to the business community at large, because we are presently subject to tax rules which encourage bad business practices. Tax regulations which run contrary to good business practices are simply bad tax regulations. Permit me to explain by reference to two of my small business clients.

Contemporary Books is a small publisher with annual sales of about $5,000,000. Some of its publications are "how to do it" books, covering such subjects as needlecraft and other hobbies. Management of Contemporary Books recognizes that certain portions of its inventory should be valued at less than cost. As the company's auditors, we likewise believe that some write-downs below cost are mandatory to present fairly on its statements the correct value of its assets.

Each year management computes the amount by which the inventory should be written-down based on experience of prior years. Such adjustment is reflected in its financial statements, but cannot be taken as a deduction for tax purposes. The amount of the adjustment is discussed with the company's bank as a routine matter. Good business practice dictates that the write-down

be made. Unfortunately, our tax rules are not in harmony with good business practices.

Another small client manufactures precision instruments which are used as measuring devices for industrial machinery. Its sales are less than $8,000,000 per year, and it has experienced exceptional growth over the past few years. As of December 31, 1980, this small company had an inventory of component parts with a cost of $180,000, which inventory was made obsolete because of a newly developed product. The company was hesitant to dispose of this inventory because of the possibility it would be used again in another product. Yet, the company needed the additional working capital which could be generated by writing-down the inventory to reflect the contingencies surrounding its value. Moreover, good business practice dictated that such an inventory of sub-assemblies should not be valued at full cost.

The company took action to meet the problem and satisfy the tax requirement for a write-off. A dump truck was loaded with the components of precision instruments and its contents were deposited at the city dump. What a great waste! Tax rules which encourage such waste must be re-examined.

The Committee on Taxation of the American Institute of Certified Public Accountants has made the following recommendation concerning inventory write-downs:

> "Section 471 should be amended to provide an equitable procedure for valuing inventories and claiming current deductions to reflect the decline in the net realizable value of inventory during the taxable year as a result of excess quantities, obsolescence, style changes, and other indications of subnormal conditions."

The above recommendation was supported by the following discussion:

"The Thor decision, in many cases, will result in a significant delay in obtaining tax deductions for inventory write-downs that have economically occurred and have been properly reflected in financial statements under generally accepted accounting principles until some later taxable year when the restrictive tests of the regulations can be satisfied. This anomaly could lead taxpayers to destroy or otherwise dispose of goods contrary to the dictates of sound business practice solely to secure the benefit of current cash flow from the deductions. The result of the destruction of such items as repair parts could be the immediate obsoleting of many kinds of consumer and industrial goods with possible serious economic consequences. To avoid this problem, we believe the statute should be amended to provide taxpayers with a means of valuing inventories at each year of not more than the net realizable value a taxpayer would expect to receive for the goods.

"The formula or other methods to be used in computing inventory write-downs may have to vary by individual taxpayer or industry. We believe, however, that in determining a net realizable value, a taxpayer's own facts and recent experience (say over the preceding 3 to 5 taxable years) would be used in making the computation."

The Small Business Legislative Council has been urging that legislation be promulgated to permit a valid write-down of inventory and thus avoid

the destruction of usable property. The SBLC has noted that many industries will have useful equipment forced into early obsolescence because replacement parts will be unavailable. The cost to our economy arising from the shortened lives of thousands of commodities, whether used in our households or our factories, is staggering.

Excess inventory reserves are commonly established for financial statement purposes by most companies, irrespective of size. Prudent management must insist upon these valuation reserves. The inconsistency which exists between income tax regulations and sound business practices encourages taxpayer responses which don't make sense from a business viewpoint. The small business community, sometimes referred to as the endangered species of our free enterprise system, urges the passage of legislation such as that proposed by Senators Moynihan and Durenberger.

RECOMMENDATIONS TO OVERRULE THE SUPREME COURT'S THOR POWER TOOL DECISION AND THE IRS REVENUE RULING ON INVENTORY WRITEDOWNS

In 1979, the Supreme Court held in Thor Power Tool Co. v. Commissioner of Internal Revenue, 439 U.S. 522, that a taxpayer must value inventory for tax purposes at cost unless market (replacement cost) is lower. As a result of the Supreme Court's decision, the taxpayer can value inventory below market or replacement cost in only two instances: 1) where the taxpayer in the normal course of business has actually offered merchandise for sale at prices lower than replacement cost, and 2) where the merchandise itself is defective.

In March, 1980 the Internal Revenue Service issued Revenue Ruling 80-60 which requires that, pursuant to the Supreme Court's Thor Power Tool decision, taxpayers using a method of inventory valuation for "excess" inventory that is not in accordance with IRS regulations must change their method of inventory valuation retroactive to taxable year 1979.

The Supreme Court's requirement that a taxpayer value his inventory at less than cost, only if, in the normal course of business he actually offers merchandise for sale at prices lower than replacement cost, is unrealistic and threatens to bring about the destruction of automobile replacement parts, parts for machinery used in factories, stores, and homes. In addition, publishing houses plan to destroy or "remainder" millions of books in the next few months because they can no longer depreciate inventories for tax purposes. Publishers expect to print fewer books in the future to avoid the chance of overstocking and to permit titles to go out of print sooner. Fewer contracts for "noncommercial" books are also likely. Other industries will have useful equipment forced into early obsolescence because replacement parts will be unavailable.

Moreover, the IRS Revenue Ruling which makes the decision retroactive to 1979 will be unduly burdensome to small businessmen who will be required to reassess their method of inventory write-downs for taxable year 1979, the books for which have already been closed. In an era when small businesses have become an "endangered species," it is untenable for the Internal Revenue Service to add an additional burden to those already facing this segment of industry. In fact, the President's White House Conference on Small Business, which concluded its proceedings earlier this year, found that many of the problems faced by small businesses are caused by the federal government.

The added cost of employing the businessman's accountant full-time or of seeking advice from a large, independent

accounting firm to reassess its method of inventory accounting will further enhance the problems many small businessmen have in remaining viable entities in these inflationary times. The additional time and money spent in determining a permissible accounting method for 1979 could be better spent in making the determination prospectively, thus avoiding duplication of effort and the tying up of essential personnel. Thus, the IRS Revenue Ruling 80-60 should be applied prospectively, beginning with taxable year 1980.

Pending legislation would prevent the IRS Ruling from being applied retroactively to taxable year 1979. The Finance Committee has recognized that the Thor Power Tool decision could cost the economy millions of dollars in coming years by shortening the lives of thousands of everyday items in more than 50 commodity lines, including automobiles, scholarly books, industrial machinery and equipment, and household appliances.

Legislation must be enacted to facilitate prospective application of the Thor decision, and, more importantly, to define a valid inventory write-down formula that accurately reflects existing conditions in industries producing these commodities.

RESOLVED

The Small Business Legislative Council urges and supports enactment of legislation to prevent implementation of the IRS Revenue Ruling 80-60 which would apply the Thor Power Tool decision retroactively to taxable year 1979. Moreover, the Small Business Legislative Council urges that legislation be promulgated to substantively overrule the Supreme Court's decision in Thor, and to define a valid inventory write-down formula to avoid the destruction of usable property. Such legislative action will eliminate the unfairness of applying the Thor decision retroactive to 1979 and will save useful equipment, replacement parts and books from forced obsolescence.

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Small Business Legislative Council*

September 24, 1981

The position paper -- Recommendations to Overrule the Supreme Court's Thor Power Tool Decision and the IRS Revenue Ruling on Invetory Write-Downs -- is supported by the following members of the Small Business Legislative Council.

Adhesives Manufacturers Assn.
Washington, D.C.

American Assn. of MESBICs
Washington, D.C.

American Assn. of Nurserymen
Washington, D.C.

American Metal Stamping Assn.
Richmond Heights, OH

American Textile Machinery Assn.
Washington, D.C.

Assn. of Indep. Corrugated Converters
Washington, D.C.

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distributors Association
Kansas City, MO

Business Advertising Council
Cincinnati, OH

Direct Selling Association
Washington, D.C.

Electronic Representatives Assn.
Chicago, IL

Florida Small Business Assn.
Jacksonville, FL

Independent Bakers Association
Washington, D.C.

Indep. Sewing Machine Dealers Assn.
Hilliard OH

Inst. of Certified Business Counselors
Lafayette, CA

Manufacturers Agents Natl. Assn.
Irvine, CA

Minnesota Assn. of Commerce & Industry
Small Business Council
St. Paul, MN

Natl. Assn. of Brick Distributors
McLean, VA

Natl. Assn. of Catalog Showroom Merchandisers
New York, NY

Natl. Assn. of Plastic Fabricators
Washington, D.C.

Natl. Assn. of Plastics Distributors
Jaffrey, NH

Natl. Building Material Dealers Assn.
Chicago, IL

-more

*Of the National Small Business Association

Natl. Coffee Service Assn.
Washington, D.C.

Natl. Concrete Masonry Assn.
Herndon, VA

Natl. Council for Industrial Innovation
Cambridge, MA

Natl. Electrical Contractors Association
Washington, D.C.

Natl. Family Business Council
Washington, D.C.

Natl. Fastener Distributors Assn.
Columbus, OH

Natl. Home Furnishings Assn.
Washington, D.C.

Natl. Insulation Contractors Assn.
Washington, D.C.

Natl. Independent Dairies Assn.
Washington, D.C.

Natl. Office Products Assn.
Alexandria, VA

Natl. Paper Trade Assn.
New York, NY

Natl. Patent Council
Arlington, VA

Natl. Precast Concrete Assn.
Indianapolis, IN

Natl. Small Business Assn.
Washington, D.C.

Natl. Society of Public Accountants
Washington, D.C.

Natl. Tire Dealers & Retreaders Assn.
Washington, D.C.

Natl. Tooling and Machining Assn.
Washington, D.C.

Natl. Wine Distributors Assn.
Chicago, IL

Power and Communications Contractors Association
Washington, D.C.

Specialty Advertising Assn. International
Irving, TX

United Federation of Small Business
LaMesa, CA

Senator PACKWOOD. We will now hear from Mr. Bevan B. Alvey, attorney from Minneapolis, Minn.

STATEMENT OF BEVAN B. ALVEY OF MINNEAPOLIS, MINN.

Mr. ALVEY. Thank you, gentlemen.

My name is Bevan B. Alvey, and I am an attorney from Minneapolis, Minn.

I represent a small closely held farm implement whosesale distributor from Redwood Falls, Minn., who is presently undergoing income tax examinations of 1978 and 1979 tax returns.

In 1978 and 1979, the taxpayers wrote down their slow-moving inventory which had been held for more than 12 months, using a factor of 30 percent below their cost.

This is based upon their own best judgment as to what price these items would ultimately be sold within a reasonably short period after the close of the tax year.

However, no offers for sale were made to retailers at this rate for a number of reasons. In all candidness one was they were not aware of the requirement of having to offer for sale items that they were certain would not be saleable at the written down price.

At the time interest rates were high, farm prices were extremely low, and in general the agricultural economy was in disarray.

Consequently, retailers had high stocks of the same inventory items that my client had in inventory.

The retailers either had high stocks of inventory or were in serious financial trouble in addition to that.

In essence, it was meaningless at that time to offer the sale items for which there really was no market.

The IRS has insisted on relying on the *Thor Power Co.* case and disallowed any writedown because no offers for sale were made and no scrapping of inventory were made, even in light of proof that in subsequent years the inventory in fact was sold at prices which justified the writedown rates.

The IRS makes its adjustments under the aegis of clearly reflected income. Clearly the Internal Revenue Service has a legitimate concern over potential abuse in the area of writedown of inventory, where the taxpayer has one eye on the value of his inventory while the other eye is on his taxable income.

However, this is not corrected by simply disallowing any type of writedown of inventory, where offers of sale or scrapping has not been made, especially when such can lead to a bad business decision.

What is needed is a uniform approach to recognizing the reality of the situation. Everyone knows that excess and slow moving of inventory depreciates when it is held over 1 year.

Inventory intensive businesses fail if inventory is held long enough and taxable income does not reflect the writedown of it.

The scrap or offer for sale rules may not be meaningful when no market exists and bad business if these items might be ultimately sold at some type of a profit later.

Businesses are not forced to offer depreciable equipment for sale in order to establish the fact that there has been depreciation recognized in the item. Uniform writedown of inventory over 3 years, as provided in S. 1276, provides a fair and uniform system

that allows certainty to the small businessman and at the same time protects the Government against potential abuses of write-downs.

Thank you very much.

[The prepared statement of Mr. Alvey follows:]

WRITTEN SUBMISSION OF TESTIMONY

WITNESS: Bevan B. Alvey, 310 Groveland Avenue, Minneapolis, MN 55403

COMMITTEE: Subcommittee on Taxation and Debt Management of the Senate Committee on Finance

SUBJECT: Writedown of obsolete and slow moving inventory items by certain small businesses (S. 1276).

DATE: September 25, 1981.

INTRODUCTION

Wood and Conn Company, Inc. (hereinafter called Wood and Conn - Moorhead) and Wood and Conn, Inc. (hereinafter called Wood and - Redwood Falls) are two Minnesota corporate wholesalers of farm machinery. During the tax years in question (1978 and 1979), each corporation had equity capital of $300,000 or less.

In accordance with GENERALLY ACCEPTED ACCOUNT PRINCIPLES, each company has followed a procedure of write downs for slow moving and obsolete inventory whereby an item is written down according to its classification as slow moving (excess inventory) or obsolete. Actual write down percentages are determined by the amount of time the item has remained in the warehouse. These percentages were calculated from emperical evidence relating to the actual sales prices of like classified goods from prior years. In the years in question, these calculations resulted in a write down percentage of 30%.

The IRS conducted an audit of both corporations for the 1978 and 1979 tax years. In reliance on the Thor Power Tool Case, the IRS agent disallowed the inventory write-downs made by both corporations on the grounds they failed to substantiate their write-down figures with evidence that the inventory items had actually been offered for

sale at those prices. Evidence was presented to the agent which showed that the eventual sale price of the inventory items in question closely approximated the amount to which they had been written down at the close of the tax year. In fact, the sales figures were less than the valuation of the inventory on the books, indicating that the companies had been conservative in valuating the obsolete and slow-moving inventory items. Nonetheless, the agent blindly applied Thor Power and rejected this evidence in the absence of proof that offerings had actually been made at the write-down figures. The disallowance of the write-down method used by the companies resulted in the assessment of additional income in the following amounts:

	1978	1979
Moorhead	$55,000	$48,000
Redwood Falls	$47,000	$13,000

DISCUSSION

I. The Retroactive Application of the Thor Power Rule to Small, Inventory-Intensive Businesses Produces Harsh and Oppressive Results.

Wood and Conn is a small farm implement business practicing in a rural area. Inventory management and accounting play a major role in the economic viability of the enterprise. In accordance with Generally Accepted Accounting Principles, they developed a write-down aging system for slow moving and obsolete goods which would reflect income as accurately as possible. Subsequently, Thor Power was decided in 1979. The Supreme Court in Thor Power stated that the company's write-down methods did not "clearly reflect income" because neither actual offerings to customers nor sales figures at the

reduced valuations could be shown by the company. Similarly, the IRS disallowed the inventory write-downs taken by Wood and Conn in 1978 and 1979 because they failed to substantiate their figures with proof of actual offerings at those prices.

Like many other small businesses, Wood and Conn simply does not command the tax planning and accounting resources of large companies. Their first notice that their inventory accouting methods ran afoul of Thor Power was received in the course of the IRS audit in 1981. Yet, the IRS has taken the position that they somehow should have known of the Thor Power rule, handed down in 1979, as early as 1978. This position clearly transcends the bounds of reasonableness and logic.

The retroactive application of the Thor Power decision produces harsh and oppressive results on small businessmen. In the case of the Wood and Conn Companies, the result was the assessment of $163,000 in additionally income for the years in question. Because of this absurd and oppressive outcome, the IRS should not be allowed to apply Thor Power retroactively to Wood and Conn and other businesses similarly situated. These companies should be given an opportunity to meet relevant standards only after reasonable notification of those standards.

II. The Inventory Write-Down Method Employed by Wood and Conn and Disallowed by the IRS Clearly Reflected Income.

As can be seen by the facts, the IRS' position as to the write downs of inventory puts Wood and Conn in a very precarious position. The harshness of the IRS' application of Thor Power is rather evident when one looks at the figures for the Wood and Conn

Companies. Emperical evidence was presented which showed that Wood and Conn - Moorhead had in reality overvalued income by their write downs of slow moving and obsolete inventory items. The IRS rejected the use of this evidence without corresponding proof of offerings of these items at the lowered valuation. This has resulted in the harsh result in which the IRS claims that Wood and Conn - Moorhead must take an additional $103,000 into income and Wood and Conn - Redwood Falls must increase income by $60,000 for the periods in question. The absurdity of this is evident when actual sales figures for Wood and Conn - Moorhead show that if anything, the aging method used by Wood and Conn tended to overvalue income. What you have in effect is a taxpayer whose methods more clearly reflect income than the "total disallowance of a reduction to market" approach which the IRS espouses when actual offerings cannot be substantiated. This "blowing of hot and cold" by the IRS in stating that inventory valuation must clearly reflect income on the one hand but disallowing actual income figures on the other if their regulations are not followed precisely, is totally ridiculous.

III. Prevailing Economic Conditions Make the Thor Power Requirement of "Actual Offerings" Unworkable

As previously mentioned, the IRS' position in the case of Wood and Conn is that even though you have given us sales figures as to the written down items, you have not shown us that these items were actually offered at the reduced valuations. The auditor stated that if Wood and Conn would have offered these inventory items for sale to its retailers at the reduced prices (market),

they would have immediately purchased these slow moving or excess goods. The subsequent sales records coupled with records of offerings would then meet Thor Power requirements. This rigid thinking fails to take into account economic conditions existing at the applicable time periods. What the IRS failed to recognize is that sales to farmers were extremely low in 1978 and 1979 in the Wood and Conn sales market due to extraneous economic variables. Consequently, the lots and warehouses of farm machinery retailers were full. Any offerings by a wholesaler during this period would not result in additional sales due to the fact that retailers had no place to store the machinery, and even if they did would not be able to afford additional debt financing with the high interest rates. Because of these economic conditions, offerings of slow moving goods to the retailers would have constituted a waste of time and money.

In contrast to this wasteful and burdensome requirement of Thor Power, the proposed legislation offers an objective, easy to administer method for determining the proper write-down of inventory which frees businesses to some extent from the problems created by cyclical economic fluctuations while at the same time enhancing business planning and inventory management.

IV. The Proposed Legislation Corrects the "No Win" Results of Thor Power's Application to the Taxpayer and the Government

The practical consequences of the application of the Thor Power doctrine can be devastating not only to the small business taxpayer but to the government as well. Mistaken business judgment, unanticipated economic trends or technological advances can all result

in the excessive build up of inventory in the typical inventory-intensive business. In order to accurately reflect income, Thor Power requires a business to offer slow moving goods at a reduced price or scrap obsolete items to take a write down on those items below cost. In the event the offers for the slow moving goods are accepted, the business takes a cut in profits and correspondingly, the government loses out on tax revenues. In the case of obsolete goods, Thor Power basically holds that they have no economic value when in fact it may be valuable for businesses to hold on to such goods for the spare parts they can provide. In both situations, businesses are apt to take a loss in profits with the government also taking a loss in tax revenues.

The proposed legislation solves these problems by allowing the taxpayer to gradually write-down inventory over a three year period. In the event that such goods can be sold more profitably at a later time, businesses may be able to realize a profit on such items with the government also getting their share of taxes.

In sum, the present system under Thor Power forces both the taxpayer and the government to take a loss without recognizing that such losses may later be turned into gains if the taxpayer is not required to immediately offer such items for sale. In contrast, the proposed legislation provides for the opportunity for the taxpayer and the government to realize a gain on such inventory items at a later date. In the meantime, the taxpayer is not forced to endure the adverse tax consequences of holding on to the inventory.

This immediate tax benefit conferred by the proposed legislation has the added advantage of materially improving the cash flow

position of many small businesses without affecting the ultimate taxability of the gains realized from the disposition of the goods. In effect, the government will be temporarily subsidizing the businessman to hold the inventory until a time comes when it can be more profitably sold. When the inventory is sold, the reduced basis as a result of the write-down will generate taxable income for both the government and the businessman. The tax benefit provided to the taxpayer by the write-down will give small businesses the added cash needed to weather an economic downturn or to invest in business expansion. This may very well produce an impetus to national economic growth.

V. The Proposed Legislation Provides Administrative Convenience to the Government and Certainty to Business Planning and Inventory Management

The Thor Power decision can be attributed in large measure to the IRS' legitimate problem of policing a subjective inventory write-down system. If taxpayers were left free to use their own best judgment in valuating inventory at year end, this could easily result in tailoring inventory values to meet perceived income reporting needs. However, it is unfortunate that taxpayers such as Wood and Conn, who have made good faith and accurate attempts at valuating inventories, must bear the brunt of potential abuses of the system.

The present legislation pending before this committee will go a long way towards alleviating the IRS' concern with uniform and accurate income reporting while at the same time relieving the burdens placed on taxpayers such as Wood and Conn. The legislation's strong appeal derives from its instituting an easily administered, objective

inventory write-down system. The fixed percentage write-down prescribed for the applicable years will make it easy for the IRS to determine whether a business is taking a proper write-down in any given year. At the same time, the taxpayer is relieved from the costly, if not wasteful, compliance with the Thor Power "offer" requirement. Business planning and inventory management will be vastly simplified and improved by taking the guess work out of inventory valuation. Uniformity of results are virtually guaranteed under the new legislation.

The improvements in inventory accounting promised by this legislation are especially valuable for small businesses such as Wood and Conn. At the very least, it will eliminate the requirement of keeping two sets of books, one for accounting purposes and one for income tax purposes. By eliminating the costs associated with complying with the stringent requirements of Thor Power, resources can be freed for uses that can contribute to real economic growth.

SUMMARY OF POINTS

1. The retroactive application of Thor Power to inventory write-downs made before the case was decided is inequitable and oppressive. Small businesses are especially prone to the problems of complying with Thor Power. At the very least, these businesses should be given a reasonable time to comply with the decision after notice was received.

2. The rigid reading of Thor Power in the case of Wood and Conn by the IRS circumvents the basic premise behind the Supreme Court decision - the "clear reflection of income." When sales

figures of a company portray a "clear reflection of income," and the IRS rejects these figures because offerings have not been substantiated is a clear distortion of the central theme of Thor Power.

3. During periods of recession and high interest rates, the Thor Power requirement of making offers of slow-moving inventory does not provide an accurate measure of inventory value and is, from a practical point of view, unworkable.

4. Thor Power requires slow-moving inventory to be offered at a reduced price in order for it to be written down below cost. The loss of profits engendered by this forced disposition is harmful both to the taxpayer and the government. By allowing the businessman to temporarily hold on to such inventory through the assistance of a write-down tax benefit, the proposed legislation allows both the taxpayer and the government to realize a gain when the inventory is sold under more profitable circumstances.

5. By instituting an objective method of writing-down inventory, the new legislation provides both the government and the taxpayer with a uniform, simplified and easily adminstered system of inventory accounting.

Respectfully submitted,

Bevan B. Alvey

Bevan B. Alvey
310 Groveland Avenue
Minneapolis, MN 55403

Senator PACKWOOD. Thank you very much.

Senator Long?

Senator LONG. I have no questions.

Senator PACKWOOD. Senator Durenberger?

Senator DURENBERGER. Just one question.

Maybe I will direct it either to Mr. Dempsey or Mr. Bergan.

Assuming that you sell your business today, how would you value, or how would the value of excess or obsolete inventory compare with the value which the IRS says you ought to maintain on an operating business?

Mr. DEMPSEY. I was in the position to buy a business on my own. From past experience I have had, there were two things that we would not take, we would not take anything that was not listed as a returnable item to manufacturers, nor would we take used machinery.

If a new prospect was brought in by one of our companies to buy our business, the recommendation that he would also he given is that you do not take anything that is not returnable.

Mr. BERGAN. Also, Senator, there is a difference that has happened through the years in trying to maintain a part system for many different types of systems we have in the field today, and because of weather conditions, we will probably order and try to anticipate, and we will be caught with an overabundance of certain parts because of weather conditions.

Now, we have to realize that our harvest today with the machines that we have to operate goes very rapidly. Harvesting of grain probably lasts 3 weeks, harvest of sugar beets, maybe 3 weeks, so the opportunity to replace parts that have been used on broken down machines is damn near impossible, so we must maintain as much inventory as we possibly can, because we are retailers, and our principal reason to be out there is to service those farmers, because I am still a believer that our small cities and towns throughout America is the backbone of America and agriculture is the only thing we have to depend upon to make the living of all the people, at least in my town, and we are there to service those people to the utmost because our time limit today is so short.

We are not in the horse-and-buggy days. We are in a very fast economy. There is no way, for instance, this year we are in a very wet area. We are taking clutches out of tractors of all makes. There is not any way that we could possibly get these parts to our place of business fast enough to keep those farmers in the field, and if that farmer loses 2 days of operation in that field, he has lost an income.

We are not talking of just one farmer, we are talking of many farmers, and therefore if we are to scrap those parts and take them out of our business, we are only delaying the repair of that combine or that tractor.

Senator PACKWOOD. Thank you very much.

Senator Moynihan?

Senator MOYNIHAN. Thank you, Mr. Chairman.

I would like to address my question to Mr. Barth, but if any member of the panel would want to comment, they may do so.

Also to my colleagues, I think we have come upon a question here which is of larger order than we first understood.

We are talking about the structure of American business in many ways, and the degree to which complexity is rewarded or punished by a tax system that did not start out to have any effect one way or another on this subject. That company that Mr. Barth describes in Chicago—an instrument firm—growing, doing well, had some developments which may have made some of its inventory less valuable than it otherwise would be. Needing capital to grow further, it fills up a truck with precision instruments, takes the truck to the city dump and dumps it.

There is something that is offensive. It offends against the spirit. You do not dump precision instruments. Perhaps old Chevrolets, I do not know if they are different [laughter], but precision instruments are the things that go click, click, click, three times. By the same token, you do not shred books.

Publishers have this particular problem, where publishing has been an industry in which people got less than might have been their optimum economic return because they liked what they were doing. That is a form of reward too, and perhaps it could he said that some of us here could do better elsewhere, but we like what we are doing.

There are some books which you publish, but only 500 people in the world will read them, and only 50 the first year. Very slowly do the books move out. Yet they are published, because there are publishing houses that will publish books only one person will read, if the books are important. Our tax code certainly should not penalize that kind of activity. Mr. Barth, is it your impression, speaking for a leading firm, Arthur Andersen, that the *Thor Power Tool* ruling does inhibit activity which could be described as socially and economically useful?

Mr. BARTH. Oh, I think so, very definitely.

The other products that might be made from these parts, and the production of goods for both consumers and industrial purposes is inhibited.

Senator MOYNIHAN. Inhibited?

Mr. BARTH. Yes.

Senator MOYNIHAN. The complexity, the diversity and to some degree possibly the development of the economy is inhibited by this?

Mr. BARTH. Yes.

Senator MOYNIHAN. Mr. Chairman, with very few exceptions the function of the Internal Revenue Code is to raise revenues, and it is not to impact in some way on the structure of the economy.

We like to have economically neutral tax code such that decisions are made in terms of what is best for the firm, best for the individual, and not what fits into the Revenue Code.

I think we have a case here where people have to behave in ways they would not otherwise behave because of the Revenue Code; is not that right?

Mr. BARTH. That is the point I was making, when I said that tax regulations which encourage bad business practices are bad tax regulations.

Senator MOYNIHAN. That is correct. Said and done. That is what it amounts to.

Senator PACKWOOD. You just said it as eloquently as it can he said.

Gentlemen, thank you very much. I appreciate it.

Let's conclude today with a panel of Jack Morrison, William Brandner, and James Caudill.

I am sorry. There is one more panel after this one.

Mr. Morrison, go right ahead.

STATEMENT OF JACK C. MORRISON, CONTROLLER AND TREASURER OF STEWART-WARNER CORP., CHICAGO, ILL.

Mr. MORRISON. Thank you, Mr. Chairman, for the opportunity to present our views.

My name is Jack Morrison, controller and treasurer of Stewart-Warner Corp., Chicago, Ill., which is now the parent company of Thor Power Tool.

Thor has paid all taxes due on the excess inventory issue.

I would like to call your attention to just a few of the substantive problems which now appear as a result of the *Thor* decision. When someone is buying a company they certainly would not consider paying full value for inventory which had been on hand for a substantial period of time and for which there was no foreseeable demand. For the owner of a company with slow moving excess stock to scrap the material simply to get a tax deduction when there will in all probability be some demand for service parts in the future is counterproductive since subsequent production in small lots will cost the consumer many times more than the original cost—providing the manufacturer is even willing to produce very short production schedules.

It seems a terrible dislocation of judgment when the tax codes permit a company to write off capital equipment, usually called fixed assets over a period of about 5 years, while at the same time excess inventory usually described as current assets cannot be written off over any reasonable period of time, even though it is patently clear that excess inventories have declining economic value. Obviously, much of the impact of the *Thor* decision could be overcome by LIFO inventory accounting—however, except for the cash consideration—affairs of business are generally more manageable and at a lower cost under FIFO inventory accounting with appropriate reserves for maintaining the net realizable valuation of inventory.

None of the courts involved in the *Thor* decision challenged the basic accounting requirement that business enterprises must value their inventories at net realizable value for purposes of their financial statements.

While the courts involved in the Thor tax case all agreed that inventories should be written down for most purposes they held that the specific terms of the 1954 Revenue Code had been misinterpreted since the Code did not specifically provide for the eligibility of such writedowns for tax purposes.

We feel that it is extremely important that the omission in the Code be corrected, since the clearly established requirements of generally accepted accounting principles should be consistent for both book and tax purposes in matters of such broad consequences as inventory valuations.

If writedowns for excess inventories are again permitted on the basis of reasonable formulas, the long-term effects on taxation will be zero.

The U.S. Treasury will of course receive full taxes on all profits from the eventual sale of the written down products.

Recognizing that the Senators have addressed this problem, under the auspices of the Small Business Committee, we encourage you to go one step further and delete the portions of the will which that restrict S. 1276 to small business.

It does not seem appropriate that small business and larger businesses have different accounting rules. An accounting rule which is sound for small business, such as S. 1276, would in general, meet the accounting requirements of larger businesses equally as well and to that end the modification of this bill to include inventory valuation problems of businesses of all sizes will be beneficial, fair, and equitable.

In summary, we feel that the law providing for inventory writedowns described in S. 1276, should be extended to all taxpayers regardless of size, and regardless of whether or not they have open tax years which may or may not be under audit. I particularly appreciate the opportunity to appear before this subcommittee, and thank you for your attention to this presentation.

Just so there is no appearance of the "wolf in sheep's clothing," I should comment that I am the former treasurer-controller of Thor, which is now a wholly-owned subsidiary of Stewart-Warner Corp.

[The prepared statement of Mr. Morrison follows:]

Remarks Before the Subcommittee on Taxation
and Debt Management, U. S. Senate Committee on Finance

I am Jack C. Morrison, Controller and Treasurer of Stewart-Warner Corporation, Chicago, Illinois.

S. 1276

I am appearing here today on behalf of Stewart-Warner as well as all affected taxpayers to comment upon, and to suggest changes to, Senate Bill S. 1276.

We compliment Senator Durenberger, along with Senators Melcher, Boschwitz, Zorinski and Grassley, for their recognition of the significant impact on business enterprises that have been required to increase the valuation of inventories for tax purposes to values which exceed the net realizable values, both under generally accepted accounting principles and in accordance with sound business practices. Recognizing that the Senators have addressed this problem under the auspices of the Small Business Committee, we encourage them to go one step further and delete the portions of the bill which restrict S. 1276 to small business. It does not seem appropriate that small business and larger businesses have different accounting rules. An accounting rule which is sound for small business, such as S. 1276, would, in general, meet the accounting requirements of larger businesses equally as well, and to that end the modification of this bill to

include inventory valuation problems of businesses of all sizes will be beneficial, fair and equitable.

We would also recommend that proposed Section 474(b)(3) of S. 1276 be amended to rectify what appears to be a typographical omission of the first two words of the sentence - specifically to insert the words "100% of."

> "(3) 100% of such inventory value as of such date if such item has been held more than 36 months." In addition, we feel it would be more realistic to accelerate the write-down periods specified in these sections, and we will be pleased to submit our recommendations if the Committee so desires.

Section 2(b)(3) includes an exception for taxpayers under audit which we consider to be discriminatory. If new rules are to be promulgated which recognize the equitable and necessary requirement for reducing inventories to their net realizable value, then we feel it to be patently unfair that the new rules not apply to all companies. We feel that the effective date should not be predicated on whether or not the Internal Revenue Service has performed, commenced, or discussed inventory write-down procedures with the taxpayer.

In summary, we feel that the law providing for inventory write-downs, as described in S. 1276, should be extended to all taxpayers regardless of size and regardless of whether or not they have open tax years which may or may not be under audit.

S. 578

Senator Moynihan, in introducing S. 578, has also recognized that inventories should not be valued in excess of net realizable

value, and under Section 1 of S. 578 has proposed legislation which would provide some relief; however, the use of the five-year experience factor does not seem to provide the same degree of relief and ease of administration for most businesses as would be available under the alternative S. 1276.

Section 2 and Section 3 of S. 578 provide worthwhile relief to business with respect to the LIFO method of tax accounting and with respect to the adoption of LIFO, and the utilization of ten-year amortization, permitted under the change in accounting rules.

We believe Section 4(a) should be expanded to include taxpayers who adopted similar methods for inventory valuation in periods prior to December 25, 1979, in order to permit them to adopt these new rules without penalty. We strongly recommend this addition since a great many taxpayers have regularly followed a policy of writing down the value of excess inventory quantities, during the years prior to the period ended December 25 1979.

Revenue Procedure 80-5, Section 3.06 - Retroactive Application by IRS

Revenue Procedure 80-5, which provides transitional rules for changes in accounting to adapt to the Thor decision, including the retroactive application of taxes and interest, should be invalidated under either S. 578 or S. 1276.

Background

It might be helpful to summarize briefly the background of this excess inventory matter. At issue in the Thor case was the method of accounting for excess inventories. The method employed by Thor, which was deemed impermissible by the Supreme Court in 1979, had been employed by a high percentage of all corporate taxpayers over a period of many decades. While the IRS had, from time to time, challenged such method, it had not ever pressed such challenges, until it made its claim against Thor. For example, Stewart-Warner was so challenged in the mid-1950s but the IRS then accepted its method of accounting after extensive discussion. It was not until 1976 - some 20 years later - when the IRS was auditing Stewart-Warner's tax years of 1972-73, that the IRS again seriously challenged this accepted method of accounting for excess inventories.

The Thor challenge arose in the late 1960s during an audit of the taxable years 1963-65.* A lawsuit was filed by Thor in the Tax Court in 1969, challenging the IRS rejection of the long established method of accounting for excess inventories. The Tax Court rendered a decision in favor of the IRS on May 6, 1975 on the grounds that the Code did not specifically permit the write-down for tax purposes of excess inventories. That decision was affirmed by the U.S. Court of Appeals on September 28, 1977.

*Large tax deductions for write-downs had been taken at that time as a result of a change in Thor's management following a careful audit of its affairs.

It was not until October 11, 1977 that the IRS issued Revenue Ruling 77-364 clarifying its position on the method of accounting for excess inventories.

None of the courts involved in the Thor decision challenged the basic accounting requirement that business enterprises must value their inventories at net realizable value for purposes of their financial statements. In the case of public companies, such inventory valuation procedures are mandatory under the Securities & Exchange Commission regulations. While the courts involved in the Thor tax case all agreed that inventories should be written down to net realizable value for virtually all purposes, they held that the specific terms of the 1954 Revenue Code had been misinterpreted by the public, since the Code did not specifically provide for the eligibility of such write-downs for tax purposes. We feel that it is extremely important that the omission in the 1954 Code be corrected since the clearly established requirements of generally accepted accounting principles should be consistent for both book and tax purposes in matters of such broad consequences as inventory valuations.

If write-downs for excess inventories are again permitted on the basis of reasonable formulas, the long-term effects on taxation will be zero. The U. S. Treasury will, of course, receive full taxes on all profits from the eventual sale of the written down products.

There is no important revenue impact arising from the retroactive application of interest, which is not deemed significant to the Treasury but the payment of which places a substantial burden upon selected taxpayers.

We encourage the Committee to amend S. 1276 to be applicable to all industry, to provide relief for those companies which have for many years followed what has always been a fully accepted accounting procedure, and so that businesses not be penalized by reason of audit in the interim periods.

We also point out the technical problem with respect to the omission of key words in proposed Section 474(b)(3) of S. 1276.

We appreciate the opportunity to appear before this Subcommittee and thank you for your attention to our presentation.

Respectfully submitted,

STEWART-WARNER CORPORATION

Jack C. Morrison
Controller and Treasurer

Senator PACKWOOD. Mr. Brandner?

STATEMENT OF WILLIAM BRANDNER, SENIOR VICE PRESIDENT AND TREASURER, HARCOURT BRACE JOVANOVICH, INC., NEW YORK, N.Y.

Mr. BRANDNER. Mr. Chairman. Thank you for the opportunity to appear before you. I am William Brandner, senior vice president and treasurer of Harcourt Brace Jovanovich, Inc. I speak in support of Senate bill S. 578.

Each year we publish more than 1,000 books for educational, scholarly, and general audiences. Our initial printing of a book and the subsequent reprintings of that book are based on sales projections. Obviously, we have no incentive to print more copies of a book than we think we can sell.

Telling a customer we are "out of stock" means losing an order—each book is unique but, nonetheless, book publishing is competitive and you can lose business being out of stock.

We tend in some instances to overprint because we are, in part, hopeful, and because book buying involves millions of individual decisions which we cannot estimate precisely as they occur.

Our experience shows that over the life cycle of a published work we remainder—remainderings being bulk sales at greatly reduced prices—or we destroy a large percentage of the copies printed. If, at publication date, we knew which books would not sell, obviously we would print fewer copies and obviate the need for later destruction.

Excess inventory is merely another cost of doing business. Many foreign governments have recognized this in their tax laws. U.S. businesses compete with foreigners who have this lower after-tax advantage.

One might ask why we hold inventories of books once they are determined to be excess stock? Why hold stock when we believe that the net realizable value is less than its cost? For scholarly books in humanities, science, medicine, et cetera, these are kept largely for their archival value—although 3 to 4 years after the original publication date, few books of this kind recover their remaining inventory cost from continuing sales. Many important scholarly research studies would not be possible if we destroyed all remaining inventory once its major sales activity subsided.

For trade books (fiction and nonfiction), after the initial year of publication in hardcover, subsequent sales are minimal. These later sales are largely predictable from the past history of that author or the book's subject matter. Excess inventory of trade books cannot be offered to the remainder market immediately. Contracts with authors frequently include provisions that the publisher will not remainder inventories of hardcover books until a period of time after the book is published in paperback—for periods of up to 5 years.

For elementary and high school textbooks, we sell these books in 24 States under statewide contracts drawn with State education departments. In many States, inventories of these books are required to be maintained on deposit in the State over the duration of the contract, which is generally a period of 5 to 7 years. Otherwise and generally, the first 2 years after publication account for more than half of all the sales of an elementary or high school textbook. After this 2-year period—in some cases, a longer period—the remaining inventory quantities can be evaluated and the excess quantities determined from past experience with similar textbooks.

For college textbooks, the bulk of the sales also occurs in the first 2 years of publication. Here, unlike school publishing, there is an active used-book market on college campuses which substantially reduces the sales potential of college textbooks once they are 1 year old. We are able to identify pretty well the excess quantities of college textbooks in our inventory. But remainder markets for college textbooks are difficult to reach; and a longer process is needed to determine if sales of excess quantities of college textbooks can be made.

Provisions of the Robinson Patman Act prevent publishers from selling portions of their inventory, the excess quantity, at reduced prices if limited quantities are sold at full price. It requires a publisher to declare a book out of print and, therefore, not available for sale at full price before they can be sold to the remainder market. Often after the initial sales periods, even for a bestseller, the publisher may have 10,000 to 20,000 copies of a book left when he knows he will sell only 5,000 copies, total, over the next 5 years.

Harcourt Brace Jovanovich, Inc., like other publishers, is reluctant to destroy books. Rather than destroy, we prefer to make them available to scholars and general readers at greatly reduced prices. We believe that a book not read is nothing at all, and that it is far

better for students and others to be able to buy remaindered books, at cheap prices, than to go emptyhanded. Even if we are able to identify excess quantities with some degree of certitude and calculate the maximum future sales value of excess quantities, we are unable for the reasons I listed here and other practical considerations, to remainder these inventories to the remainder market or donate these to charitable organizations at the time the determination of their diminished future value is made.

An objective standard for determining excess inventory, such as that in S. 578, is greatly needed. Otherwise, Harcourt Brace Jovanovich, Inc. will be forced to destroy huge quantities of books to obtain current tax deductions. We believe that calculating 5 years of past experience of actual excess inventories will provide a formula for calculating a deduction for excess inventory that can be reasonably audited by the IRS. This method has precedence in the tax law. It follows the concepts of the well-recognized Black Motor Co. formula for determining a writeoff for bad debts. The 5 years experience rule merely documents what a businessman knows from his experience—what in his inventories will not sell. If subsequent experience becomes more favorable, the formula for future years' excess stock writeoffs will reflect that favorable experience.

We also support the concept for determining excess inventory under S. 1276, even though, this does not address the individual nature of excess inventory as does the experience concept in S. 578. Further, excess inventory is an accounting and tax problem faced by all taxpayers, not simply taxpayers having equity capital of $25 million or less. We believe S. 1276 is too narrowly focused. As a result of this narrow focus, S. 1276 must further complicate the Internal Revenue Code by requiring definitions of "qualified small business," "controlled groups," and "equity capital" for corporations and noncorporate business. We submit that Congress' goal should be to resolve the problem faced by taxpayers by use of the least complicated statutory provisions.

Thank you for the opportunity to appear before you to state our views on S. 578 and S. 1276.

Mr. Chairman, I also wish to submit for the record of these hearings a statement by Mr. Martin E. Tash, chairman, president and treasurer of Plenum Publishing Corp.

Senator PACKWOOD. I will put his statement in the record.

[The prepared statement of Mr. Tash follows:]

THE LANGUAGE OF SCIENCE
Plenum
PUBLISHING CORPORATION

New York • London • Washington, D.C. • Boston

STATEMENT OF MARTIN E. TASH, CHAIRMAN, PRESIDENT AND TREASURER

PLENUM PUBLISHING CORP.

AND CHAIRMAN OF THE TAX COMMITTEE OF THE ASSOCIATION OF AMERICAN PUBLISHERS

This statement is being prepared for the record of the hearings of the Subcommittee on Taxation and Debt Management Generally of the United States Senate Committee on Finance on Senate Bill S-578.

Plenum Publishing is engaged in the business of publishing scientific, technical and medical books and journals and reprints of other scholarly works. Our principal customers are scientists, scholars, research libraries and other libraries throughout the world. Each year we publish approximately 300 new books, 160 journals and 100 reprints of scholarly works and we have approximately 3,500 active titles.

The nature of our published works and our customers is such that it takes a long period of time for initial printings of a book or a reprint to sell out. Under the present income tax regulations, we are forced to make an economic determination of quantities in inventory and destroy those books which we believe will not sell in a relatively short period of time. Last year we had to destroy 332,500 copies of books to obtain a current tax deduction.

We believe it is far better to hold books in inventory so that they eventually can be made available to scientists and libraries, however we cannot afford to hold excess inventories of scientific books and scholarly reprints under the current income tax regulations.

Plenum Publishing Corporation • 233 Spring Street, New York, New York 10013 • Tel.: 212 255-0713 • Cable: PLENUMCORP/Telex: 421139

We believe an objective standard is needed to determine a current tax deduction for excess stock. This is an ordinary cost of doing business in the publishing industry. An experience factor such as that in S-578, can be determined by publishers and applied to their inventory to determine the amount of excess stock on hand. It seems to us far better to use this formula to calculate a current tax deduction as opposed to destroying huge quantities of books, which we and other publishers are otherwise forced to do to obtain a tax write off for excess inventory under the present tax law.

Moreover, under an experience formula approach, should a publisher have windfall profit from a publication he thought to be unsalable, the formula is self correcting as the revenues obtained from that eventual sale would be taxed. Under the current tax rule, that revenue is lost forever because a book destroyed can never be sold.

I urge the committee to act in favor on S-578.

Martin Tash

Martin E. Tash

Senator MOYNIHAN. Mr. Caudill?

STATEMENT OF MR. JAMES KENNETH CAUDILL, TAX COUNSEL, BATUS, INC., LOUISVILLE, KY.

Mr. CAUDILL. Mr. Chairman, I am James K. Caudill, tax counsel of BATUS, Inc., headquartered in Louisville, Ky.

BATUS is the common parent corporation of an affiliated group of U.S. corporations which includes Brown & Williamson Tobacco Corp.; the Kohl Corp.; Gimbel-Saks Retailing Corp.; and Appleton Papers, Inc.

BATUS is wholly owned by B.A.T. Industries, Ltd., a publicly held United Kingdom corporation. B.A.T. is the ultimate parent of a group of corporations engaged worldwide in tobacco, retail, paper, grocery, cosmetics, packaging materials, and other industries.

It is the sixth largest foreign corporate investor in the United States. BATUS is a holding and management company for most of B.A.T.'s investments in this country. The BATUS group has over 46,000 full-time employees in the United States.

My remarks today will be addressed solely to the reasons why BATUS supports repeal of the LIFO conformity requirement, which S. 578 would accomplish.

The LIFO method of inventory tax accounting, which is authorized by Internal Revenue Code section 472, is conditioned upon the

requirement that earnings as reported for tax purposes also be used in financial reports to stockholders and creditors.

This is the only example of forced book/tax conformity in the Internal Revenue Code. This requirement has deterred many taxpayers from adopting LIFO for tax purposes and has caused taxpayers who use LIFO tremendous frustration and uncertainty.

The LIFO conformity requirement is an anachronism which seriously impedes realistic financial reporting for a great many taxpayers without raising additional revenue to the Government.

When the LIFO method was first introduced into the Internal Revenue Code in 1938, it was limited to the tanning and nonferrous metals industries where inventories are actually moved first from the top of the heap on a last-in, first-out basis.

The committee reports show that advocates of LIFO were thinking of the actual movement of goods rather than dollar value pools.

At that time many if perhaps not most accountants doubted that LIFO would ever become an acceptable financial accounting method for other industries in which the typical flow of inventory of goods was not off the top of the pile on the last-in first-out basis.

Today it is almost universally the rule that LIFO and other inventory accounting methods measure costs in an accounting sense and not the physical flow of goods; therefore the underlying rationale, if there ever was a rationale for the conformity rule, is completely obsolete.

As a result of inflation in recent years, LIFO is now the generally preferred method of inventory accounting in the United States. It more nearly matches current costs than does the alternative first-in and first-out or FIFO method which was the generally preferred accounting method some 40 years ago.

Today the conformity requirement no longer furthers any known tax policy of the United States. In addition to being an anachronism, the conformity rule has proven to be very uncertain and unworkable and poses particularly difficult compliance problems for many U.S. LIFO subsidiaries of foreign corporations which do not use or cannot use LIFO.

Under current law, based on a 1978 IRS ruling, the financial reports to a foreign parent corporation must be presented strictly on a last-in, first-out basis.

B.A.T. is required under British law and British accounting methods to use first in, first out. The BATUS financial personnel therefore are forced to use a variety of very rigid and technical exemptions from the conformity rule which seriously hamstring their ability to pass very necessary information to the parent company.

I might point out that naturally the top executives of the English company think in terms of first in, first out, because LIFO is unknown to Great Britain and not acceptable.

As I said before, the conformity rule does not further any tax policy of this country and should be repealed.

Thank you.

Senator MOYNIHAN. I thank you, Mr. Caudill, and as you know, we very much agree, and that is why the legislation we have before us would put aside that rule.

I think it is the case, Mr. Morrison, that Stuart Warner is the owner of Thor Power?

Mr. MORRISON. Yes, that is true. I was there at the time it took place, and I was made controller and treasurer.

Senator MOYNIHAN. You were present at the creation.

Mr. MORRISON. Yes.

Senator MOYNIHAN. Well, we may be closer to a resolution than we thought.

Mr. Chapoton this morning was really not adament, he was not enthusiastic. It is not the business of an Assistant Secretary to be enthusiastic about anything, but there was a visible movement. We have a tax rule, which is simply a provision designed to raise revenue ~~which~~ encourages bad business practices, and that cannot be a good rule.

I wanted to ask if I may, Mr. Brandner, there is one statement: you said the 5 years' experience will merely document what a businessman knows from his experience what in his inventory will not sell.

Now, I wonder if you did not mean what proportion of his inventory?

Mr. BRANDNER. That is correct.

Senator MOYNIHAN. You have a thousand books on your list, and you can know that x percent will not sell, but you do not know which of them, or else if you knew that, you would know the future, which is difficult.

Mr. BRANDNER. Senator, if I might elaborate on that point, each year for financial accounting purposes we are required to review our inventories and write down that portion of our inventory which we believe will not realize its cost.

Arthur Andersen is our accountant, and they will not render an opinion on our statements unless we make that adjustment each year.

We tested the 5-year experience concept to see if it would produce somewhat the same result as that judgment review of inventory as to why it would not sell. What we did, we went back 5 years and took all books that went out of print during that period, traced back their life history of number of copies printed and eventual number of copies remaindered and destroyed, and we produced within a relatively minor dollar amount the same answer.

Senator MOYNIHAN. Is that right?

Mr. BRANDNER. Yes.

Senator MOYNIHAN. Would it be a burden to you, if we ask you to give the committee an account of that exercise?

I do not want to learn any trade secrets, but——

Mr. BRANDNER. I do not have the details with me, but I could forward them.

Senator MOYNIHAN. I mean could you prepare it?

Mr. BRANDNER. Surely.

Senator MOYNIHAN. And so here we would have a specific on where a firm went through the effort to see how would this work, and I take it your judgment is that it would not.

Mr. BRANDNER. Yes.

[Additional document follows:]

Harcourt Brace Jovanovich, Inc.

757 THIRD AVENUE, NEW YORK, N.Y. 10017 TELEPHONE (212) 888-5613 CABLE: HARBRACE

J. WILLIAM BRANDNER
SENIOR VICE PRESIDENT AND TREASURER

October 28, 1981

Honorable Daniel P. Moynihan
Committee on Finance
2227 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Moynihan:

At the September 25th hearings of the Finance Committee's Taxation and Debt Management subcommittee, you asked me to summarize the results of our study of the application of the provisions of your bill S. 578 to Harcourt Brace Jovanovich, Inc.'s ("HBJ") "excess inventories" using HBJ's actual experience for a five-year period. This letter will summarize our work.

Since 1919, HBJ has identified its excess inventories by determining the expected net realizable value of its inventory on hand at year end. This evaluation was undertaken each year and was accomplished by comparing each title in inventory to future sales estimates based upon management's judgment in light of past business experience. The cost of the quantity of inventory not expected to be sold at full price was written down to its expected recoverable value.

Under generally accepted accounting principles, HBJ was required to make an adjustment to its financial statements for the reduction in its inventory value. Prior to 1979, HBJ, with the concurrence of its certified public accountants, made a similar adjustment each year for tax purposes. Over the years, the Internal Revenue Service agents auditing HBJ's income tax returns reviewed, and in some instances raised questions with respect to, the procedures HBJ followed in determining its excess inventory write-down. Only minor adjustments resulted from such examinations prior to 1979, since the agents concluded that the writedowns were consistent with HBJ's business experience.

As I indicated in my testimony, we have reviewed HBJ's inventory records to determine how the five-year experience formula of your bill would apply in HBJ's situation. We were also vitally interested in determining the order of magnitude of the work and cost involved in meeting the provisions of your bill.

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First, let me outline briefly HBJ's inventory situation. HBJ publishes and maintains inventories in four groups of books, i.e., School (elementary and secondary school textbooks); College (undergraduate level textbooks); Trade books (books of general reader interest); and Academic Press (scholarly books). It is also important to note that we do not have the detailed information upon which our study was based in computer access form, except in the Academic Press area. The great bulk of the information upon which our work is based was assembled manually. We have determined that our costs of establishing the excess inventory adjustment under your bill's five-year experience formula was approximately $23,700, consisting of staff and computer operating time. Essentially, this is a one-time cost, and related to all of our titles (approximately 35,000). The annual cost of updating the formula calculation should be minimal.

We compared our December 31, 1979 inventory master file in the School, College, and Trade groups of books (approximately 20,000 titles) to our inventory master file for each year in the period from 1974 through 1978. Each title that appeared in inventory at any time during the period from 1974 to 1978, but not appearing in the 1979 inventory, was determined to have ended its business life during the five-year period. A representative sample of these discontinued titles was reviewed to determine the number of individual copies of each title that were printed, their costs, the number that were disposed of in the remainder market, the remainder value (sales price), the number that were destroyed, and the percent of such items of the total production, and the percent of the cost of the remaindered and destroyed books of the total production cost of the title.

It is this latter percentage that would be applied to the ending inventory that would determine the writedown for "excess inventory" at the end of a year. A similar calculation would be made on an annual rolling basis (including the most recent year, and deleting the earliest year), thereby annually updating the percentage to reflect HBJ's most recent five-year experience. The procedure under the formula is self-correcting. That is, if the actual sales experience is better or worse than the percentage calculated under the formula, the variation would be reflected in the calculations, and adjusted by the subsequent percentage determination. Furthermore, the procedure, and the results that flow from the formula's application provide clear and relatively simple audit trails that are readily verifiable by any Internal Revenue Agent auditing HBJ's returns.

The following reflects the procedure and its results in table form.

	SCHOOL	COLLEGE	TRADE
Number of Titles Reviewed	25	28	36
Total Copies Printed and Bound	3,142,073	1,861,998	641,755
Number of Copies Destroyed and/or Remaindered	179,786	84,639	237,067
% of Copies Destroyed and/or Remaindered	5.72%	4.55%	36.94%
Production Cost	$ 1,848,946	$ 2,575,789	$ 449,168
Cost of Copies Destroyed and/or Remaindered	$ 105,759	$ 117,198	$ 165,923
Less - Proceeds from Remaindering	1,232	32,066	74,178
Net Cost of Copies Destroyed and/or Remaindered	$ 104,527	$ 85,132	$ 91,745
% of Production Cost	5.65%	3.30%	20.43%
Production Cost of All Bound Books 1976 - 1980	$99,946,000	$28,027,000	$14,601,000
Write-Off Based on Five-Year Experience	$ 5,647,000	$ 925,000	$ 2,983,000

For purposes of testing this part of our work, we compared the total write-downs arrived at under the five-year experience calculation with the total write-downs under the five-year period ended December 31, 1980, calculated under the sales projections basis. The comparison points out that the variation in results under the two methods was not material.

The following summarizes our calculations in these areas.

	SCHOOL	COLLEGE	TRADE
Write-Off Based on Five-Year Experience Formula	$5,647,000	$ 925,000	$2,983,000
Write-Off Based on Sales Projections	4,856,000	1,894,000	3,615,000
Variation	$ 791,000	$ (969,000)	$ (632,000)

As can be seen, the variation totals $810,000, which constitutes 7.82 percent of the writedown based upon the sales projection basis. It is to be noted that the formula provides self-correction of the variation. No revenue loss will result to the Treasury, since the variation is only a timing variation under the method of calculation.

Our procedure with respect to the Academic Press (scholarly books) group was slightly different as a result of the way that our computer records are organized in that area, and the fact that a remainder market does not exist for such books.

The experience formula was applied to all 15,000 active scholarly titles. The total number of copies printed of each title was determined, from which was subtracted the total number of copies sold, the total number of copies distributed as complimentary copies, and the number of copies remaining in inventory. Since a remainder market does not exist in scholarly works, the difference represented the number of copies destroyed.

This calculation established a destruction rate of in the range of from 16 to 17 percent. We compared this result (using a 16 percent destruction rate) to the writedowns based upon management's sales projections, and found no significant difference.

The calculation we made in this area was skewered slightly since the experience covered a period somewhat more than five years. This resulted from the fact that some titles had been in inventory more than five years. In our view, this does not result in a significant difference in results, and upon enactment of S. 578 our records will be modified so as to meet the five-year experience period.

We appreciate having the opportunity of submitting this information to you. If you or your associates have any questions, please feel free to call.

Very truly yours,

J. William Brandner

Senator MOYNIHAN. Well, I thank the panel very much.

I am particularly pleased to see where the *Thor* controversy began, in the person of Mr. Morrison, and I want to thank you gentlemen.

We will move along because there is a vote coming up, and I want to make sure that all witnesses are heard. We would be particularly grateful if we could get from you, Mr. Brandner, an accounting of that exercise you carried out. It would lend reality to this somewhat abstract subject.

Thank you, gentlemen, very much.

Senator McCarthy is in the audience, and he is not scheduled as a witness, but does he appear for the purpose of speaking to this subject? If so, he is most welcome to join us.

Senator MCCARTHY. Would you like me to testify?

Senator MOYNIHAN. Please testify. Yes, sir.

You are a well-known author. Your books have never been remainders, but you must have met some poor wretched soul who wanted to be a well-known.

Senator MCCARTHY. They did surface one of my books just 2 weeks ago, so I have a very deep feeling about what is being talked about here today.

Senator MOYNIHAN. Well, we would like to hear from you, sir.

Senator McCarthy. I was reassured. They were quite modest. They had only 2,000 books left out of 8,000.

They had not anticipated this. When they publish my books, they operate on a very narrow margin, and I assume that if this inventory privilege were not allowed, they would not have published me in the first place.

You can understand what a loss that would be.

In the broader stream, Senator, I can recall where the issue of postal rates was under consideration in the 1950's, it was strongly argued when you raise postal rates on magazines, many magazines would disappear.

Congress prevailed, and the position of the Treasury and many magazines did disappear, things like the Yellow Book, magazines in stock, even competitive news magazines, so decisions of this kind, at least that decision did have a consequence, and decisions of this kind, I think dealing with an industry as the publishing business, which is precarious at best, can have serious consequences, if we acknowledge just the other day, Mr. Leary testified before another congressional committee, saying he thought the only way to save the country was to suppress television, and I am inclined to agree. I think you either have more of it or less of it, and possibly if you had more, the ultimate distraction would take place, and people would begin to think rather directly again. But in the interim while it is still competitive, I think the only hope is in book publishing, otherwise we contribute to the condition of enthrapy in the country, in which the only rule was that of chaos and disorder, and the book publishing business, if they are allowed to keep the books for more than 2 years, you know, a good book should last more than 2 years, they can be encouraged to do that, to have something as modest as what they are asking for in the way of inventory treatment, that should be permitted by the Congress.

I do not like to have to use myself as a good example, you can understand that, but I did have a book published about 5 years ago, called America Revisited. It did fairly well here, it had the front-page review of the Times Book Review, but in any case they kept the book for 5 years.

I do not know whether this inventory issue bore upon it, but recently it has been translated into Taiwanese and into Russian. If the inventory methods had been different, it is possible that the book might have been burned or destroyed 3 years ago.

Senator Moynihan. That was your book in which you traced the travels of De Tocqueville.

Senator McCarthy. Yes, his travels and also his thoughts.

In any case, I think the issue of preserving books for periods of 5 to 10 years inventory is effectively helped by the conditions under which people are distracted from thought today would be a significant contribution to political and cultural order.

Senator Moynihan. Thank you very much. That is very generous of you to say it.

Your argument is eloquent. I heard Henry Kissinger once say it has the further advantage of being true.

Senator McCarthy. I am happy to accommodate you.

Thank you very much.

Senator MOYNIHAN. Thank you, sir. You have heen very generous with your time.

Our remaining panel is composed of Mr. Donal E. Flannery of Peat, Marwick, Mitchell & Co., and Mr. John H. Fitch, who is vice president for government relations of the National Association of Wholesalers-Distributors.

Mr. Flannery?

Mr. Flannery, you are listed first, and perhaps you can proceed, sir.

STATEMENT OF DONAL E. FLANNERY, MEMBER OF THE TAX ACCOUNTING SUBCOMMITTEE OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. FLANNERY. Thank you.

I am here representing the Tax Accounting Subcommittee of the Federal Tax Division of the American Institute of Certified Public Accountants.

With respect to the inventory writedown issues, we believe that the present tax law and the income tax regulations as interpreted by the Supreme Court in the *Thor Power* decision and as administered by the Internal Revenue Service, is entirely too restrictive. We think it is out of touch with reality for all taxpayers, not just those with excess stock, but all taxpayers with inventories which have declined in value below their costs.

We believe that we need workable rules for all taxpayers which reflect both good business sense and good tax sense.

We think that the law should provide for predictable writedowns based on the actual experience of the particular taxpayer or based on other acceptable means of proof.

As has been stated before, we do not believe the law should penalize the taxpayer for retaining older goods and inventory, if that makes sense in the taxpayer's business and if it makes sense to the customers served by that business.

We think that S. 578 is a very reasonable approach, it is definitely a step in the right direction, and we just would add a couple of points.

First of all, we think it is very important that the bill, as it does should cover all inventories and not be restricted to the term of excess stock as defined by the Internal Revenue Service, because essentially all inventories have the same potential for decline in value below cost, without regard whether they are slow moving or subnormal goods or whatever.

We also believe that the bill's use of an aging formula is important, and while we think the taxpayer's own particular experience is very important, we do not think that those should be the sole criteria.

You have the problem of new businesses coming into being that do not have a track record of their own, and I think for some industries, a pure aging formula may be inappropriate.

We would leave that for the particular industries to raise those specific problems.

On the writedown issues, we think that the bill should take into account and provide for transitional records for people just starting

in the system, especially for the newer taxpayers and for smaller taxpayers.

Finally we would like to support specifically LIFO conformity repeal, which is contained in S. 578. We think it is rather clear that the validity of the LIFO inventory method for Federal income tax purposes is well established, and we think the conformity requirement is an obsolete provision and is therefore unnecessary.

Thank you, sir.

Senator MOYNIHAN. Well, sir, that had the economy of a well-developed mathematical mind, if I assume you to be a member of the Tax Accounting Subcommittee of the American Institute of Certified Public Accountants, speaking for the profession, you endorse this legislation?

Mr. FLANNERY. Yes, we do, Senator.

Senator MOYNIHAN. It is an important thing for us to learn, it is of necessity and properly we do hear from taxpayers in these matters, but there are professions associated with these activities, the attorneys, the Bar, the Tax Bar, and the CPA's, and it is an important factor that you have come and given the endorsement of the American Institute to such legislation, and this committee is grateful to you, and we wish you would express our appreciation to the institute for doing that.

Mr. FLANNERY. Thank you.

[The prepared statement of Mr. Flannery follows:]

Testimony of

Donal E. Flannery

Member

Tax Accounting Subcommittee

American Institute of Certified Public Accountants

Before the

Subcommittee on Taxation and Debt Management

of the

Senate Committee on Finance

September 25, 1981

Good morning! My name is Donal E. Flannery, and I am a partner in the Washington, D.C. office of the CPA firm of Peat, Marwick, Mitchell & Co. I am a member of the Tax Accounting Subcommittee of the Federal Tax Division of the American Institute of Certified Public Accountants and am here today representing that organization.

The AICPA believes that present law should be amended to provide an equitable procedure for valuing inventories that have declined in value below cost. In many cases, the present law does not recognize business realities and badly serves businesses, their customers, and the economy overall.

A business may have excess or subnormal inventories which it retains in stock for good business reasons. Spare parts, for instance, may never be sold, but they may, on the other hand, greatly extend the useful life of a customer's machinery or equipment. Without available repair parts, more expensive repairs or replacement costs will impact the business or be passed on to the public. The business, its customers, and the economy benefit from the spare parts inventory, but the present tax law, as interpreted in the Thor Power Tool decision, encourages businesses to dispose of spare parts inventories.

Under present law, in order to write down inventory to a value below cost, a company must generally sell (or offer for sale) the inventory within 30 days after the close of the tax year or actually scrap the goods. The value of the immediate cash flow from the tax benefit of the writeoff will often be worth more than the future cash flow (if any) of the sales of the inventory or later writedowns in accord with Thor. This cash flow problem is particularly acute in these times of high interest rates.

We believe that a more reasonable approach (such as the one taken in Senator Moynihan's bill) should be taken in allowing inventory writedowns. Generally, we favor the use of the taxpayer's own facts and most recent experience in computing the net realizable value of inventories, but we would not exclude other methods of proving that inventories have declined in value below cost. We understand the concerns of the Department of the Treasury over "arbitrary" writedowns and commend Mr. Chapoton for his expressed willingness to seek a more equitable solution to this problem than presently exists.

We also believe that the bill should provide relief for a variety of inventory problem situations, such as goods which are slow moving, excess, subnormal, obsolete, out of style, damaged, defective, and so forth. Senator Moynihan's bill, as we read it, would cover such situations, but we hope that this will be made very clear in the committee report.

We believe that Senator Moynihan's bill will benefit businesses of all sizes. It should be noted, however, that in some cases, smaller businesses with less sophisticated accounting systems, may not have adequate records to prove their inventory dispositions below cost over the past five years. Depending on how extensive the records to support inventory writeoffs will be, some businesses will not be able to take advantage of the bill's benefits until they have maintained the required records to prove their experience, in some cases for up to five years after enactment. A possible solution would be to allow a company to use its prior year's experience in the first year, its immediately preceeding two year's experience in the second year, and so forth until the five year base of experience is built up. We believe that all businesses could take advantage of the bill, but we urge the Subcommittee simplify the recordkeeping requirements as much as possible in order to

facilitate its use.

We commend the Subcommittee for taking up this important problem and urge the Subcommittee to consider in future hearings various other important inventory issues such as: repealing the LIFO conformity requirement, repealing the required LIFO inventory profit recognition in certain liquidations, allowing fair and simple use of regularly published government indexes, and simplifying LIFO pooling requirements. Relief is needed in these areas for inventory intensive businesses, which did not benefit to the extent that capital intensive businesses did in the Economic Recovery Tax Act. There are a number of legislative and administrative initiatives in these areas, and we believe they deserve a full hearing by you.

Thank you for this opportunity to testify. I am submitting a copy of our Thor Power Tool recommended tax law change for the record. I would be pleased to respond to any questions you may have.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS—RECOMMENDED TAX LAW CHANGE

CODE SECTION—471—INVENTORY WRITE-DOWNS

Recommendation

Section 471 should be amended to provide an equitable procedure for valuing inventories and claiming current deductions to reflect the decline in the net realizable value of inventory during the taxable year as a result of excess quantities, obsolescence, style changes, and other indications of subnormal conditions.

The *Thor Power Tool Co.* (439 U.S. 522, 1979) decision has had a significant impact on the inventory valuation methods used by many taxpayers. In that case, the Supreme Court interpreted the existing statute to allow deductions for the decline in the value of "excess" inventories only in the taxable year in which the excess quantities are offered for sale at reduced prices or otherwise disposed of as provided in the regulations. The rules contained in the regulations for determining write-downs are in certain instances more restrictive or require a greater degree of precision in application than common business practices today generally provide.

The Thor case also contained a factual dispute as to allowable write-downs for obsolete, damaged and defective goods, etc. The IRS contended that such write-downs were allowed because the goods were scrapped by Thor soon after write-down. Thor argued that 40 percent of the obsolete parts remained unscrapped three years later. In this regard, the regulations (Sec. 1.471-2(c) with respect to subnormal goods are ambigious and contain an impractical requirement of an actual offering of the subnormal goods during a period which ends not later than 30 days after the inventory date. In the interest of sound tax administration, there is a need in the law for more certainty, clarification and recognition of business realities.

The *Thor* decision, in many cases, will result in a significant delay in obtaining tax deductions for inventory write-downs that have economically occurred and have been properly reflected in financial statements under generally accepted accounting principles, until some later taxable year when the restrictive tests of the regulations can be satisfied. This anomaly could lead taxpayers to destroy or otherwise dispose of goods contrary to the dictates of sound business practice solely to secure the benefit of current cash flow from the deductions. The result of the destruction of such items as repair parts could be the immediate obsoleting of many kinds of consumer and industrial goods with possibly serious economic consequences. To avoid this problem, we believe the statute should be amended to provided taxpayers with a means of valuing inventories at each year of not more than the net realizable value a taxpayer would expect to receive for the goods.

The formula or other methods to be used in computing inventory the write-downs may have to vary by individual taxpayer or industry. We believe however that in determining a net realizable value, a taxpayer's own facts and recent experience (say over the preceding three to five taxable years) would be used in making the computation.

Senator MOYNIHAN. And now a concluding witness, Mr. Fitch, on behalf of the National Association of Wholesalers-Distributors.

STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT OF GOVERNMENT RELATIONS OF THE NATIONAL ASSOCIATION OF WHOLESALERS-DISTRIBUTORS

Mr. FITCH. Thank you, Senator.

My remarks are quite detailed, and I will leave those for the record.

Senator MOYNIHAN. The remarks shall be placed in the record in full.

Mr. FITCH. I feel somewhat like I am preaching to the choir, but I think the record should remind the members of the subcommittee who are not here that your amendment dealing with the write-down issue was passed by the Senate last year as part of a continuing resolution. Evidencing the fact that they have dealt with this issue before and have approved it by voice vote.

I would like also to point out for the record that when you offered your bill in the nature of an amendment during the Economic Recovery Tax Act debate, the condition upon which you withdrew that amendment was assurance by Chairman Dole that he and Treasury would seek a substantive resolution to the problem.

Mr. Chapoton might wish to review that dialog between you and Chairman Dole.

I would personally like to thank you and Keith Martin, your tax counsel, for all of the effort you folks put in on this issue.

As you can well imagine, the inventory writedown issue for wholesaler-distributors is one of their major economic concerns.

I would take issue with Mr. Chapoton's remarks that Treasury is opposed to "depreciation" of inventory.

I would point out that there is a direct parallel to that concept using the economic tax act ACRS provisions which allow capital intensive businesses 15/10/5/3 depreciation for their assets. For wholesaler-distributors, their main asset is their inventory—so an objective writedown hand standard as set out in S. 578 and S. 1276 could be used if that is the way the committee wants to go.

Our association did a survey of our members. The results are in my statement. I just call your attention to it, and its results——

Senator MOYNIHAN. Where is it in your statement?

Mr. FITCH. Well, in the summary, it is on page 2 of the statement, while it is not exactly scientific in the sense that we tested it and did all of that sort of thing, it does quite readily point up the problem.

Basically we went to our members with a set of questions including the gross sales data, to get a feel for the effect of the *Thor* decision and whether based on size they were on LIFO or FIFO.

I might point out that the basic results of the survey are quite clear. Those who are on FIFO, the *Thor Power Tool* decision dramatically affects the availability and cost of spare parts, not only

for industry, but for consumers also. For example, if your central air-conditioning unit, lawn mowers, refrigerators break down but for the lack of a spare part, you will have to buy a new refrigerator or pay a higher price for a part if one is available.

That kind of logic is in here.

I would also point out on pages 14 through 17, there are a couple of letters that we have included in the statement that give you real life examples of the impact *Thor* has on our members.

One is from a heating and air-conditioning wholesaler in Illinois, the other is an electronics distributor in Richmond, Va. I think previous witnesses here today have pointed out the economic ramifications from their standpoint, and I would just like to restate that.

This has significant public policy impact, a broad impact, beyond just the technicality of the issue.

With that, I leave my statement to your review.

[The prepared statement of Mr. Fitch follows:]

SUMMARY STATEMENT
JOHN H. FITCH, JR.
VICE PRESIDENT-GOVERNMENT RELATIONS
NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS
INVENTORY SIMPLIFICATION AND REFORM

INTRODUCTION

For wholesaler-distributors, federal tax policy relating to inventory valuation is a critical capital retention issue.

In times of inflation and high interest rates, it can facilitate the needed operating capital without the necessity of accessing external capital markets.

Moreover, since the average wholesaler-distributor has 80% of his investment in inventory and receivables, the tax treatment of those assets will determine to a great extent the price and availability of replacement parts and equipment. On the average, it costs an additional 40% per year to maintain inventory.

In the current economic "stagflation" environment, sound tax policies that put certainty in the law and which stimulate and encourage productivity are essential.

Revitalization of the one trillion dollar wholesale distribution industry is a key element in that policy.

WRITE-DOWN OF SLOW-MOVING OR OBSOLETE INVENTORY

It is with the above goal in mind that NAW conducted a survey of its membership on the write-down issue; the results set forth below are quite revealing.

SUMMARY ANALYSIS
OF
NAW INVENTORY SURVEY*

Responses: 1909		Survey Total(%)
Gross Sales Volume:	$ 0 - $ 500,000	0
	$ 500,000 - $ 1,500,000	10
	$ 1,500,000 - $ 3,000,000	17
	$ 3,000,000 - $ 5,000,000	17
	$ 5,000,000 - $10,000,000	23
	$10,000,000 - $15,000,000	12
	$15,000,000 - $20,000,000	6
	Over $20,000,000	16
What is your current inventory valuation method?	LIFO	53
	FIFO	36
	OTHER	10
Given Thor decision, will you change to LIFO:	YES	17
	NO	84
If no, because:		
LIFO statistics & records too complicated		56
Immediate tax consequences too severe		21
Other.		17
Given Thor decision, have or will you change policy regarding retention or scrapping old inventory items?	YES	61
	NO	39
If yes, what change?		
Offer affected inventory at reduced prices		39
Retain affected inventory for shorter period		25
Scrap affected inventory		42
Other		5

(Continued)

*Percentage totals may not total 100% due to rounding off of figures or multiple answers.

Responses: 1909		Survey Total(%)
If inventory practices are changed, what might be consequences for your customers?		
Higher prices		31
Reduced number & availability of spare parts		47
Forced obsolescence		32
Other		8
What advice did you receive from accountant or others?		
None		32
Change to LIFO		17
Offer affected inventory at reduced prices		36
Retain affected inventory for shorter period		18
Scrap affected inventory		36
Other		8
Consistent with Rev. Ruling 80-60, if there is an offer to sell inventory at reduced prices, are write-downs practical?	YES	44
	NO	57

Without a doubt, the results of the survey, but for some slight commodity line-specific deviations, clearly indicate that the IRS position, as upheld by the U. S. Supreme Court in the Thor Power Tool Co. decision, has put wholesaler-distributors "between a rock and a hard place"; that is, to comply with Thor, "excess" inventory will be scrapped or will be retained for shorter periods of time, causing higher prices and reduced numbers and availability of replacement parts and equipment.

Moreover, the remedy (switching to LIFO) has been rejected by a preponderance of the companies affected by Thor based on the severe and immediate tax consequences resulting from the switch to LIFO, and the complexities of LIFO once the switch has been made.

The survey also substantiates the presumption that smaller businesses are on FIFO, and larger businesses, on LIFO. However, it also points up the fact that even given a simplified LIFO, close to 20% would stay on FIFO for other reasons; thus, a need to conform the lower-of-cost-or-market valuation method to actual business practices.

The public policy implications based on these data are quite obvious: Without LIFO simplification and a more reasonable and equitable method to value excess inventory, consumers will not have readily available spare parts for their major home appliances, heating and air-conditioning units, etc., and will pay significantly higher prices for those that are available. The same is true for the industrial customers of wholesaler-distributors who rely on the

immediate availability of part for their machines and equipment used in the manufacture of products.

For business, the ramifications are even more significant. The most serious scenario would be that manufacturers would produce less; wholesaler-distributors would retain and distribute less; retailers would have less to sell; profits would be down; unemployment up; and the entire business sector would remain quagmired in stagflation.

These results clearly support NAW's strong interest and endorsement of legislation to correct this problem and the commitment of its resources to ensure its enactment.

ADDITIONAL INVENTORY ISSUES THAT NEED CONGRESSIONAL ATTENTION:

1. Repeal of LIFO Recapture Provision of Windfall Profits Tax Act of 1980.

   Beginning in January, 1982, the LIFO reserve of a corporation that liquidates or partially liquidates will be taxed as ordinary income rather than at capital gains rates. This provision is punitive and works an extreme hardship on family-owned, closely-held firms such as wholesaler-distributors.

   The provision's effective date was postponed for 2 years in order to give Congress an opportunity to hold hearings and receive public comments (no hearings had been held on the issue). To date, Congress still has held no hearings. NAW urges repeal of the provision on its merits, or in the alternative, an additional one-year postponement of the effective date to allow Congressional hearings.

2. Further LIFO Simplification.

   - Increase one pool test to $10 million in annual gross sales from current $2 million level.
   - Allow 100% PPI/CPI indexing for valuation purposes.
   - Allow use of link-chain valuation method where internal indexes are used.
   - Limit number of pools to 15 major PPI categories (11 CPI categories; 1 with further detailing left to taxpayer).
   - Increase to 10 the number of years a taxpayer has in which to bring back into income write-downs under FIFO when switching to LIFO.

3. Technical Corrections to the Economic Recovery Tax Act of 1981.

   - Allow use of one pool for business who originally qualify for the provision but who experience subsequent growth beyond the $2 million in annual gross sales threshold.

   - Allow use of three-year spread for those who elect LIFO while they are on the 10-year spread in accordance with Revenue Proc. 80-5.

FULL STATEMENT

Mr. Chairman, Members of the Subcommittee, my name is John H. Fitch, Jr., Vice President - Government Relations, for the National Association of Wholesaler-Distributors.

It is a pleasure to appear here today to express the views of NAW on legislation to provide for the write-down of excess or obsolete inventory.

Before I begin my testimony, I would like to commend Senators Moynihan and Durenberger and the cosponsors of their bills for recognizing an important, but highly technical, capital retention issue -- particularly for inventory-intensive wholesaler-distributors.

National Association of Wholesaler-Distributors

The National Association of Wholesaler-Distributors is a federation of 121 national wholesale distribution associations which have an aggregate membership of approximately 45,000 wholesaler-distributors, with 150,000 places of business. The members of our constituent associations are responsible for 60% of the $1 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 2.5 million, of the 4 million Americans who work in

wholesale trade. Thus, although the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is most significant. A list of NAW's Association members is provided at Appendix A.

THE INDUSTRY

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely-held, family-owned businesses. Of the 238,000 merchant wholesaler-distributor corporations filing tax returns in 1977, 99% had assets of $10 million or less. These smaller firms accounted for about 58% of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2% of the firms controlled about 88% of the assets and accounted for approximately 80% of sales.

The wholesale distribution industry provides year-round employment for over 4 million individuals. In 1977, average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15% above those in private industry ($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U. S. economy.

Industry sales totaled approximately $955 billion in 1980 and are expected to reach over $1 trillion in 1981, according to United States Commerce Department estimates.

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

According to IRS figures, the total value of the inventories mentioned above for merchant wholesaler-distributors at the end of 1977 was $61.6 million. Census Bureau figures for 1980 show that figure to be $99.6 million on sales of over $900 billion.

As can be seen, wholesale distribution is an inventory-intensive business. Virtually 80% of a wholesaler-distributor's asset base is inventory and receivables.

Consequently, the method used to value that inventory must be based on economic and business considerations in order to ensure sufficient cash flow from retained earnings to support operations and growth.

An inflationary environment not only exacerbates the problem, but coupled with a tax system that fails to recognize the actual business practices and accounting methods used to value that inventory as under the FIFO (first-in-first-out) method, or needlessly complicates the method as is currently the case with LIFO, it even further intensifies the problem. To provide support for that assumption, I reference a study commissioned by the Distribution Research and Education Foundation (DREF) and carried out by the senior faculty of the Graduate School of Business at the University of Michigan entitled Inflation and the Wholesale Distribution Industry.

I have copies of that study with me today which I will provide to your staff.

Both S 578 and S 1276 address the FIFO write-down issue forthrightly and provide reasonable solutions to the problem.

Let me briefly discuss the issue as it relates to wholesaler-distributors and then specifically review the two bills, S 578 and S 1276, within that context.

OBJECTIVE WRITE-DOWN STANDARD FOR FIFO USERS

Pursuant to the U. S. Supreme Court decision in Thor Power Tool Co. vs. Commissioner 439 U.S. 522 (1979), the Internal Revenue Service issued Revenue Ruling 80-60 and Revenue Procedure 80-5.

In the Thor Power case, the taxpayer used the "lower of cost or market" method of valuing inventories for both financial accounting and for income tax purposes. The taxpayer wrote down what it regarded as "excess" inventory to its net realizable value which, in most cases, was determined to be scrap value. The taxpayer determined that these articles were "excess" inventory because they were held in excess of any reasonably foreseeable future demand although such inventory was not scrapped or sold at reduced prices. The taxpayer retained the excess items in inventory and continued to sell them. The taxpayer contended that by writing down "excess" inventory to scrap value, it thereby reduced its inventory to "market" (net realizable value) in accord with its "lower of cost or

inventory to scrap value, it thereby reduced its inventory to "market" (net realizable value) in accord with its "lower of cost or market" method of accounting. The Commissioner of Internal Revenue disallowed this write-down.

The Supreme Court in Thor Power stated that sections 446 and 471 of the Internal Revenue Code vest the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflecting income. The Court affirmed the lower court's decision, sustaining the Commissioner, that although the taxpayer's write-down of excess inventory did conform to the best accounting practice in the trade or business and thus satisfied the first test of section 1.471-2(a) of the regulations, it failed to satisfy the second test of section 1.471-2(a), that it clearly reflect the taxpayer's income. The Court stated that where a taxpayer, under the "lower of cost or market" method of accounting, values its inventory for tax purposes at "market" (replacement cost), the taxpayer is permitted to depart from replacement cost only in specified situations described in sections 1.471-2(c) and 1.471-4(b) of the regulations. When such a departure to a lower inventory valuation is made, the regulations require that it be substantiated by objective evidence of actual offerings, sales, or contract cancellations and further require that records of actual dispositions be kept. The Court concluded that because the taxpayer provided no objective evidence of the reduced market value of its excess inventory, its write-down was plainly inconsistent with the regulations and was properly disallowed by the

inventory nor sell or offer it for sale at prices below replacement cost.

The Thor Power case affirmed the method of accounting for inventory valuation established under the income tax regulations where the lower-of-cost-or-market method is applicable. In using the lower-of-cost-or-market method, the regulations require a taxpayer having "excess" inventory to value such "excess" inventory at replacement cost (if lower than actual cost as defined in section 1.471-4 of the regulations), unless the goods have been scrapped or have been sold or offered for sale (at a lower price) within the meaning of the regulations under section 471 of the Code. (The "prescribed method.")

In Revenue Procedure 80-5, the Commissioner has granted consent for taxpayers to change from a method of accounting for inventory valuation of "excess" inventory, that is not in accordance with the "prescribed method." The Commissioner's consent is applicable for the taxpayer's first taxable year ending on or after December 25, 1979. In order to implement the decision of the Supreme Court and under the authority contained in section 1.446-1(e)(3)(ii) of the regulations, the Commissioner has prescribed certain procedures with respect to the change in method of accounting including a provision that will allow taxpayers to treat the change in method either as a change initiated by the taxpayer or as a change not initiated by the taxpayer.

NAW strongly supports the position that business should have available a choice of LIFO and FIFO rather than being forced indirectly to adopt LIFO. As shown above, present Treasury rulings require either an offering at the reduced price or scrapping to support FIFO write-downs. Neither method is applicable to a wholesaler-distributor's inventory. A retailer can reduce his entire stock of men's trousers below cost and expect to sell all or a large percentage at the reduced price, but the likelihood of a parts distributor selling his entire line of slow-moving or obsolete parts at reduced prices is almost nonexistent.

Relegating potentially usable, but not currently salable, parts to the scrap pile is equally absurd. Not only are the economy and consumer impacted by the total unavailability of replacement parts for older units, but the distributor bears the cost of model or other changes mandated by the manufacturer. Moreover, in the case of long-lived assets -- such as industrial and commercial tools and equipment, consumer appliances, and heating and air-conditioning units -- the wholesaler-distributor has an agreement with the customer (generally a manufacturer or retailer) to keep spare parts for those items on hand for the life of those assets for quick availability.

A valid formula write-down procedure, as set forth in S 578 or S 1276, would more accurately reflect the conditions that exist in a wholesaler-distributor's inventory as they concern obsolescence or slow-moving items and should be enacted. Obsolescence and slow-

moving parts for long-lived assets cannot be ignored; they are real and must be dealt with -- not by rules which have no relationship with economic reality, but by a reasonable, rational approach that this Subcommittee can provide. We believe these bills do just that.

In order to provide the Committee with a more graphic and statistical grounding for this position, a summary analysis of data taken from a survey of all 121 national commodity line associations members of NAW is set forth below. The figures are quite revealing and strongly support the position set forth in these bills.

General Analysis

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

SUMMARY LIST OF THOR SURVEY*

Responses: 1909		Survey Total(%)
Gross Sales Volume:	$ 0 - $ 500,000	0
	$ 500,000 - $ 1,500,000	10
	$ 1,500,000 - $ 3,000,000	17
	$ 3,000,000 - $ 5,000,000	17
	$ 5,000,000 - $10,000,000	23
	$10,000,000 - $15,000,000	12
	$15,000,000 - $20,000,000	6
	Over $20,000,000	16
What is your current inventory valuation method?	LIFO	53
	FIFO	36
	OTHER	10
Given Thor decision, will you change to LIFO:	YES	17
	NO	84
If no, because:		
LIFO statistics & records too complicated		56
Immediate tax consequences too severe		21
Other		17
Given Thor decision, have or will you change policy regarding retention or scrapping old inventory items?	YES	61
	NO	39
If yes, what change?		
Offer affected inventory at reduced prices		39
Retain affected inventory for shorter period		25
Scrap affected inventory		42
Other		5

(Continued)

*Percentage totals may not total 100% due to rounding off of figures or multiple answers.

Responses: 1909		Survey Total(%)
If inventory practices are changed, what might be consequences for your customers?		
Higher prices		31
Reduced number & availability of spare parts		47
Forced obsolescence		32
Other		8
What advice did you receive from accountant or others?		
None		32
Change to LIFO		17
Offer affected inventory at reduced prices		36
Retain affected inventory for shorter period		18
Scrap affected inventory		36
Other		8
Consistent with Rev. Ruling 80-60, if there is an offer to sell inventory at reduced prices, are write-downs practical?	YES	44
	NO	57

There were 1909 responses from individual corporations representing 92 commodity lines. This represents 78% of the total number of commodity line associations.

Of those responding, 1,019, or 53%, indicated they were on LIFO; and 887, or 46%, indicated their accounting method was FIFO or other.

If terms of company size, 67% of the respondents had gross annual sales of $10 million or less, and 44% had annual gross sales of $5 million or less.

Broken down according to LIFO and FIFO, 55% of those in LIFO had $10 million or more in annual gross sales; 45% had $15 million or more in gross sales; and 23% had $20 million or more in gross annual sales.

Conversely, 80% of those respondents who indicated they used the FIFO method of inventory valuation had gross annual sales of $10 million; and 55% indicated gross annual sales of $5 million or less. This clearly shows that smaller businesses use the FIFO method rather than LIFO.

Of those respondents on FIFO, 84% indicated they would not switch to LIFO given the U. S. Supreme Court decision in Thor Power Tool Co.

Of that 84%, 56% indicated that their reason for not switching to LIFO was its complexity, while 21% would not switch because immediate tax consequences were too severe.

In response to the question regarding what changes would be made to accommodate the Thor decision, 67% of the respondents indicated they would retain the affected inventory items for a shorter period or scrap them.

In determining what economic consequences that action would have, 78% of the respondents indicated higher prices and a reduced number and availability of spare parts.

Finally, 57% of the respondents indicated that for a wholesaler-distributor, it was impractical to offer to sell affected inventory at reduced prices before writing it down. This is based on the nature of the wholesale distribution industry in that its customer base is industry, retailers, commercial or government users whose

purchases are stimulated by need rather than price. Thus, offering goods at reduced price will not, per se, produce a sale.

Without a doubt, the results of the survey, but for some slight commodity line-specific deviations, clearly indicate that the IRS position, as upheld by the U. S. Supreme Court in the Thor Power Tool Co. decision, has put wholesaler-distributors "between a rock and a hard place"; that is, to comply with Thor, "excess" inventory will be scrapped or will be retained for shorter periods of time, causing higher prices and reduced numbers and availability of replacement parts and equipment.

Moreover, the remedy (switching to LIFO) has been rejected by a preponderance of the companies affected by Thor based on the severe and immediate tax consequences resulting during the switch to LIFO, and the complexities of LIFO once the switch has been made.

The survey also substantiates the presumption that smaller businesses are on FIFO, and larger businesses, on LIFO. However, it also points up the fact that even given a simplified LIFO, close to 20% would stay on FIFO for other reasons; thus, a need to conform the lower-of-cost-or-market valuation method to actual business practices.

The public policy implications based on these data are also quite obvious: Without LIFO simplification and a more reasonable and equitable method to value excess inventory, consumers will not have readily available spare parts for their major home appliances,

heating and air-conditioning units, etc., and will pay significantly higher prices for those that are available. For industrial customers the same situation would exist for their on-line machines and equipment that produce the goods for defense and consumer consumption.

For business, the ramifications are further compounded. The most serious scenario would be that manufacturers would produce less, wholesaler-distributors would retain and distribute less, retailers would have less to sell, profits would be down, unemployment up, and the entire business sector would remain quagmired in stagflation.

Mr. Chairman, in order to illustrate the significant economic impact this ruling has on the average wholesaler-distributor, I'd like to quote from a couple of our members who have written us about the problem.

-- A heating and cooling wholesaler-distributor from Zion, Illinois:

> "Late in our fiscal year, when it became evident that we would have no option other than LIFO or write-ups, we began throwing away old parts and inventory. Last year we threw away almost $5000.00 worth of old inventory, and over the course of the last eight months have been systematically destroying obsolete and old controls which have a limited usefulness. Generally dealers will not buy them at a reduced price unless they need them right then.

They too have to pay accelerated taxes under the Thor decision and cannot afford to stock these items. It is cheaper to destroy obsolete or esoteric items than to save them on the off chance of a future sale. Our business sells furnace and air-conditioning controls. In the future, someone's 10-year-old furnace, which could have been repaired with a part the government 'made' us throw away, will have to be replaced. This wastefulness will certainly encourage obsolescence and contribute to higher prices.

Under the old system, when written off parts were sold, the government got the benefit of the taxes, and the homeowner got the benefit of the part. Because of the Thor decision, the homeowner will not get the benefit of the part, might possibly have to replace an entire unit rather than just one part, and will pay a higher price for the unit to cover the cost of items thrown away. The government still gets the taxes.

Another factor, which was not discussed in the questionnaire, is the Thor penalty for experimentation. In the past, when we have experimented with a new line, we have been able to write off items which were slow in gaining momentum. If a new line failed, write-offs cushioned the loss until the items were finally sold. Several years ago, we began carrying a line of solar collectors. We

knew they would be slow movers, but wanting to encourage conservation, we decided to take the risk. Because of the Thor decison, we have had to write up our three-year-old inventory of $500-each solar collectors. We don't want to throw them away, but the tax price for keeping them is too steep. America has been able to grow because change, experimentation, and risk-taking have been rewarded. The Thor decision has changed all that.

If there is anything else I can do to help make our legislators aware of a need for a change in the law, please advise me. Because of this decision, we incurred almost $30,000 of accelerated taxes last year and will have to throw away thousands of dollars of inventory in the future because it is cheaper to throw it away than to pay the taxes. It is worth my time and energy to help change this situation."

The risk-taking and innovation which characterize the entrepreneurial spirit of the free enterprise system has been seriously affected.

-- An electronics wholesaler-distributor from Richmond, Virginia:

"Enclosed is the survey form concerning the impact the Thor decision and Revenue Ruling will have on our company. Inasmuch as the cost of eliminating any obsolescence

factor from our inventory would cause our company to pay approximately $100,000 in additional taxes over the next ten years, we have undertaken a very vigorous program to determine -- as far as possible -- parts, and in some cases, entire product lines which move too slowly for us to be able to carry them. Individual parts are being offered at reduced prices and will thereafter be scrapped. We will also discontinue handling a number of manufacturers' lines as a result of this decison. The overall effect will be lower availability of electronic parts for the consumer; this, in turn, will result in higher costs as consumers find they must replace equipment which otherwise could have been repaired."

LEGISLATIVE REMEDY FOR WRITE-DOWN PROBLEM

Currently, before the Subcommittee are two bills that deal with the write-down issue -- S 578 and S 1276. I might point out that there are several bills on the House side that also deal with this issue -- HR 2319 (Nowak); HR 3086 (Jenkins); and HR 3202 (Marriott).

S 578. Sponsored by Senator Moynihan (NY), and cosponsored by Senators East (NC); Heinz (PA); Symms (ID); Eagleton (MO); Williams (NJ); Baucus (MT); and Melcher (MT), S 578 basically allows the write-down of excessive inventory (defined as inventory which reasonably can be expected to be disposed of at less than full

realization of its cost) to its net realizable value using a 5-year experience factor for that item or line.

On the plus side, the bill conforms the law to current practices set forth in the accounting profession's Generally Accepted Accounting Principles (GAAP).

On the negative side, S 578 restricts its use to those firms which have been in business for at least five years; it does not provide for an objective, audit-proof standard; and, at least initially, would require relatively costly and burdensome administration.

S 1276. Sponsored by Senator Durenberger (MN), and cosponsored by Senators Boschwitz (MN), Grassley (IA); Melcher (MT); and Zorinsky (NE), S 1276 would allow the write-down of "excess" slow-moving or obsolete inventory after 4 years. The write-down would begin in year two and would be 33% per year over the next three years.

Unlike the Moynihan bill, S 1276 would limit its application to firms of $25 million in net worth or less. Translated into annual gross sales for the wholesale distribution industry, $25 million in net worth would equal $150 to $180 million in annual gross sales.

The major distinction between S 578 and S 1276 is the objective, audit-proof standard in S 1276 which directly parallels [illegible] simplified accelerated depreciation schedule 15-10-5-3 rec[illegible]

enacted as part of the President's Economic Recovery Tax Act of 1981.

NAW strongly supports the enactment this year of either proposal, S 578 or S 1276, and views both as significant steps toward relieving an overwhelming and unnecessary cost of carrying inventory which is slow-moving, obsolete or excess for reasons beyond the control of the wholesaler-distributor and ensuring the low-cost availability of spare parts for long-lived consumer and industrial items.

ADDITIONAL INVENTORY ISSUES

While the write-down of inventory is vital to wholesaler-distributors on FIFO, the need is great to simplify and reform the LIFO method of inventory for those currently using it or for those who wish to use it, but can't because of its complexity and cost (mostly small businesses). It is with that in mind that NAW urges Congressional action on the following inventory reform and simplification items:

Tax on LIFO Reserves

The Oil Windfall Profits Tax Act of 1980 contains a provision, offered on the Senate floor at the request of Treasury, that taxes a LIFO reserve upon liquidation of a corporation under Section 337 of the Code. There was no debate on this controversial provision, nor was there any indication that it would apply to any corporation

other than an oil company. Therefore, there was no consideration of its effect on small business.

Section 403(b) of the Oil Windfall Profits Tax Act requires those on LIFO to treat the LIFO reserve as ordinary income upon liquidation of a corporation.

A common method by which a business is transferred is through the sale of business assets. The assets are sold, and to avoid double taxation (gain to the corporation on sale of assets and gain to the shareholder upon liquidation), the corporation is liquidated under Section 337 of the Code. The proceeds of the sale are distributed to the stockholder or stockholders.

The Service, having previously been requested to review this fact situation, held that "the 'tax benefit rule' does not apply to the bulk sale of LIFO inventory pursuant to a plan of liquidation under Section 337 of the Code." (Revenue Ruling 74-431 C.B. 74-36, 9).

> "The 'tax benefit rule' provides that the recovery of an amount that was deducted from income in a prior year must be treated as income in the year recovered to the extent the deduction resulted in tax saving." (Ibid.)

LIFO, the ruling held, does not create a deduction that can be recovered.

Nothing has changed as far as LIFO is concerned since the issuance of the Ruling, except that more and more businesses are looking to LIFO for relief from inflation. The Treasury's response is to tax proceeds not heretofore taxable and deemed not to have conferred a tax benefit to the taxpayer because the taxpayer elected LIFO. It almost smacks of retribution.

This was Treasury's provision; unfortunately, Congress, in its desire to pass an Oil Windfall Profits Tax Act, did not give sufficient consideration to the adverse effect of this provision on small business. Fortunately, on the other hand, Congress has time (barely) to reverse itself on this issue, and we strongly recommend that it do so.

The effective date of the controversial provision was delayed two years until January 1, 1982, in order to give Congress an opportunity to review its effect. However, to date, Congress has failed to review this provision via the hearing process. We are now faced with the enactment of a provision that has serious consequences for the small, family-owned, closely-held business.

NAW strongly urges repeal of the provision or, at a minimum, a further one-year delay in its effective date to give this Committee and the House time to receive public comments and input.

The recapture provision places a roadblock in the ability of a family-owned, closely-held business to dispose of itself other than

through the merger or acquisition route. Further, it can significantly reduce the value of the business for sale purposes, thus placing a severe financial hardship on the owner upon disposition.

LIFO Simplification

While some measure of LIFO simplification was enacted as part of the Economic Recovery Tax Act of 1981, more is needed.

NAW would urge the following simplification measures be enacted:

-- Increase the one pool test to $10 million in annual gross sales from the current $2 million.

-- Allow 100% indexing to the PPI/CPI for valuation purposes.

-- Allow use of the simpler link-chain method of valuation where internal indexes are used.

-- Limit number of pools to the 15 major PPI categories (11 for the CPI) with further detailing left to the taxpayer.

-- Increase to 10 (from the current 3) the number of years a taxpayer has to bring back into income write-downs under FIFO when switching to LIFO.

There are currently several measures in the Senate and House that would accomplish these objectives: S 1180 (Mitchell); HR 2319 (Nowak); HR 3606 (Gradison); HR 3202 (Marriott); and HR 2949 (Heftel).

ECONOMIC RECOVERY TAX ACT OF 1981 - LIFO PROVISIONS

Finally, I would like to identify some questions with regard to the LIFO provison of PL 97-34 which I believe are germane to the Technical Corrections Act now being formulated. They are:

-- Once a wholesaler-distributor has initially qualified for the one-pool test ($2 million in annual gross sales), may that wholesaler-distributor continue to use one pool regardless of growth in annual sales beyond $2 million?

NAW strongly supports that option.

-- If a wholesaler-distributor has complied with Rev. Proc. 80-5 and is spreading the tax consequences of the Thor ruling over 10 years, can that wholesaler-distributor take advantage of the newly enacted 3-year spread if during the course of the 10-year period the wholesaler-distributor elects LIFO?

NAW strongly supports that option.

CONCLUSION

The impact of the proposals set forth in this statement not only makes the LIFO choice more acceptable, but has an equally important effect on capital retention.

During an inflationary period when most interest rates are high, LIFO results in a reduced income tax liability which can be deferred so long as inventory levels and prices remain at least as high as when LIFO was adopted because current revenue from operations is more accurately reflected. This leads to internally generated capital that can be used to finance operations and growth rather than borrowing short term money at exorbitant interest rates.

Given today's economy and the projections for the foreseeable future, LIFO can help realize the desired goals of both business and the Congress, provided business is not denied access to it by complexities mandated by Treasury and not inherent in the theory of LIFO inventory accounting. Moreover, for those who choose to remain on FIFO, a write-down standard which reflects reasonable business practices rather than theoretical groundings should be available.

It is the primary function of this Subcommittee, both collectively and individually, to ensure these reforms are enacted in the 97th Congress.

Finally, I would like to personally express my appreciation for the work Senators Moynihan and Durenberger and their staffs did to develop this legislation in partnership with the diverse segments of the business and professional community.

Through their efforts and yours, Mr. Chairman, the attention directed toward reform and simplification of inventory valuation, both in the House and the Senate, would not have been possible.

APPENDIX A

National Wholesaler-Distributor Organizations
Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers
American Dental Trade Association
American Jewelry Distributors Association
American Machine Tool Distributors' Association
American Supply Association
American Surgical Trade Association
American Traffic Services Association
American Veterinary Distributors Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Association of Footwear Distributors
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Ceramics Distributors of America
Cooperative Food Distributors of America
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesale-Distributors
  American Institute of Kitchen Dealers

Distributors Council, Inc.
Door & Hardware Institute
Drug Wholesalers Association

ectrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.

Farm Equipment Wholesalers Association
Flat Glass Marketing Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Foodservice Equipment Distributors Association
Foodservice Organization of Distributors

General Merchandise Distributors Council

Hobby Industry Association

International Ceramic Association
The Irrigation Association
Institutional & Service Textile Distributors Association, Inc.

Laundry & Cleaners Allied Trades Association

Machinery Dealers National Association
Mass Merchandising Distributors Association
Material Handling Equipment Distribution Association
Monument Builders of North America-Wholesale Div.
Motorcycle Industry Council
Music Distributors Association

National-American Wholesale Grocers' Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Brick Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Manufacturing Opticians
National Association of Marine Services, Inc.
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Recording Merchandisers, Inc.
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Distributors
National Association of Tobacco Distributors
National Association of Writing Instrument Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Independent Bank Equipment Suppliers Assn.
National Industrial Belting Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmiths' Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Plastercraft Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National & Southern Industrial Distributors Associations
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
Northamerican Heating & Airconditioning Wholesalers
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Scaffold Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Steel Service Center Institute

Toy Wholesalers' Association of America

United Pesticide Formulators & Distributors Association

Wallcovering Distributors Association
Warehouse Distributors Association for
  Leisure & Mobile Products
Watch Materials & Jewelry Distributors Association
Water and Sewer Distributors Association
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association
Wine & Spirits Wholesalers of America, Inc.
Wood Heating Alliance
Woodworking Machinery Distributors Association

Senator MOYNIHAN. I am going to ask something more of you, sir.

You just said something that I know is a specific that would be of interest to the committee and to the Senate, which is the degree to which, absent a reasonably thriving spare part component in a manufacturing system, we get to the point where one thing breaks in the machine, and you throw out the machine. This just cannot in the large sense be economic, but the tax law can bring it about.

Earlier you heard the gentleman from Arthur Andersen say that the tax code should not encourage bad business practices. This goes beyond bad business practices.

It makes business practices that are actually uneconomic in the larger sense.

We know that every American household has four or five fixtures or machines that do break and somehow do not get fixed anymore. Something offends against the notion of throwing out the washing machine for lack of a small part in the motor. That cannot be good for our economy, nor for our souls.

In the same way, we heard earlier today from the representative of Arthur Andersen, about the manufacturer of precision measuring instruments in Chicago, who with an inventory that might sell, but needing capital, did the best thing given the law, which was to fill a truck up with precision scientific instruments and take the truck out to the city dump and dump it.

Mr. FITCH. I think if you read the letters that I have included in my statement, they illustrate further the example that Mr. Barth used.

I would emphasize also that many of our members supply parts to manufacturers, and are required by that manufacturer as a customer service, to carry the parts for that machine as long as it is "on line" because if that machine goes down, it costs that manufacturer money. Even if that machine has a useful life of 15 or 20 years and they may not ever use a spare part, the distributor is required to keep those parts in stock, just in case.

I think the previous witness talked about combines and the problems related to obtaining spare parts when they broke down and that time-delay cost the farmers money. Well, that quite clearly illustrates my point also.

Senator MOYNIHAN. So there can be a time when in the large interest of the economy, a particular machine should not break down.

Mr. FITCH. Exactly. The defense industry is a good example of that.

Senator MOYNIHAN. So you want that machine never to need a spare part.

But the spare parts have to be there in the event it might and if the tax code penalizes prudent behavior, you have an uneconomic outcome.

Mr. FITCH. Exactly.

Senator MOYNIHAN. The tax code is designed to discourage bad practices in some ways, I suppose. There is always an element of morality. That is why we have a tax on rum, but in the main, the tax code is designed to obtain revenue for the Government.

Mr. FITCH. Another thing that bothers me, Senator, is the fact that the Treasury Department implies that businesses in general would tend to act in a "less than moral way," to manipulate inventory to maximize benefits and minimize liabilities.

That may be true in certain cases, but in the main the individuals that I have talked with buy and sell inventory on the basis of good business practice, not whether or not they need, more or less, a tax liability.

Senator MOYNIHAN. If I may say, the previous administration was welcome to send up representatives telling us in what way business should behave morally or immorally, and so forth.

But this is an administration committed to the proposition that a businessman should behave, as the famous Adam Smith said, not for your interest, but for his own. The object of business is to make money in an efficient way. The question of what is moral or immoral behavior is not something the tax code ought to inquire into. What Congress should inquire into is what causes distortions and undersirable consequences, such as the shredding of books and the dumping of precision instruments and the failure to run maintenance systems that are in the large interest of the economy.

Mr. FITCH. Excuse me, Senator.

There is another aspect of this issue that has not really been dealt with, but was pointed out in one of the letters set forth in my statement—that is the innovation aspect.

In other words, this wholesaler-distributor bought solar panels with hopes that solar energy is an available source of energy, and that they would have solar panels readily available and to distribute at a reasonable cost to their customers.

But in this instance, the *Thor* decision obviated against the keeping of those solar panels until such time as they could generate a market for them—so they got rid of the panels.

Senator MOYNIHAN. That is another example. Obviously when we have legislation like this, we tend to look for friendly witnesses, but we welcome any witness who wishes to appear.

We have had a long morning, a succession of informed and capable statements, each one more emphatic than its predecessor in support of some resolution of this matter, and principally I think in support of the legislation which I introduced. With that we conclude the morning, and I thank you all for your presence.

[Whereupon, the subcommittee was adjourned at 11:20 o'clock a.m.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Statement of

Willis D. Gradison, Jr.
(1st, Ohio)

Before the

Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate

September 25, 1981

STATEMENT OF THE HONORABLE WILLIS D. GRADISON, JR.
MEMBER OF CONGRESS
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE
SENATE COMMITTEE ON FINANCE

Mr. Chairman, a complete exploration of the Internal Revenue Service's tax treatment of inventory writedowns must include a brief discussion of general inventory accounting simplification. I have been working in a bipartisan effort, along with Representative Henry Nowak, Senator George Mitchell and others, to simplify the last-in first-out (LIFO) inventory accounting system, thereby making its use more attractive to small business. In an inflationary period, businesses prefer to use LIFO because they can subtract the costs of their most recently purchased higher-priced inventory from their taxable profit on the sale of that inventory. By deferring a portion of their tax liability during those periods of rising costs, small businesses can effectively hedge themselves against inflation's full impact. Under the alternative first-in first-out (FIFO) accounting system, a business can only subtract the lower cost of its older inventory and will thereby realize greater taxable profits.

Unnecessary regulatory barriers to LIFO conversion have deterred small businesses from switching to this generally accepted accounting system. Recognizing this fact and the issue's importance to the small business community, Congress included several LIFO simplification measures in the Economic Recovery Tax Act of 1981. Under the Act:

1. businesses with less than $2 million in gross annual assets for 3 years (ending with the current tax year) may elect one inventory pool for purposes of LIFO accounting. Prior to this change, huge numbers of separate inventory pools, with separate record-keeping systems for each pool, were required.

2. taxpayers electing LIFO will have 3 years (beginning with the year of LIFO election) to restore inventory writedowns taken in years prior to the year of LIFO election to income. Formerly, all writedowns had to be restored in the year of LIFO conversion.

3. the Secretary of Treasury is required to prescribe regulations providing for the simplification of LIFO inventory accounting through the use of published government indexes. All indications are that those regulations should be released by the end of the year. Under current law each LIFO business is required to complete its own internal price index.

Although these reforms constitute a constructive first step, they are not sufficient to promote capital formation by small businesses. Several crucial revisions were not included in the Administration's tax bill. To clear the remaining roadblocks the following proposals are necessary:

1. Delay the enactment of Section 403(b) of the Windfall Profit Tax bill (WPT).

   This provision seeks to recapture LIFO tax savings when an inventory is liquidated through the sale of a business, or otherwise, beginning on December 31, 1981. Therefore, after that date, a corporation using the LIFO accounting method will be required to recognize as ordinary income upon sale of its business the difference between the LIFO and FIFO basis of its inventory.

   Such a provision will severely deter LIFO adoption and is directly contrary to the Economic Recovery Tax Act's express legislative purpose. It will reduce the price of a LIFO business because such a business will come with a large tax debt.

   Section 403(b) was added to the WPT bill as a Senate floor amendment due to the urging of the Treasury Department in a last minute compromise. The House-Senate

Conferees accepted the provision, but only with the proviso that its implementation date be delayed until December 31, 1981 (two years) to give both House and Senate tax writing committees time to hold hearings on the proposal. In the Conference transcript, even Treasury officials conceded that enactment should not come before adequate formal Congressional consideration. To date, this proposal has been studied by no committee in Congress. Experts on the Joint Tax Committee and the House Ways and Means Committee believe that the provision is flawed, that it is overly broad and onerous, that it was passed before LIFO simplification emerged as an Administration goal and that it will deter LIFO conversion by all businesses even though less burdensome alternatives exist to accomplish the same end. I propose that implementation of this provision be delayed until both Houses of Congress have the opportunity to scrutinize the changes made in Section 403(b) and legislate knowledgeably.

2. use 100 percent of the Consumer Price Index (CPI) or the Producer Price Index (PPI) in lieu of individually prepared internal price indexes.

Treasury regulations should allow businesses to use 100 percent of the CPI and the PPI. Public hearings indicate that the Treasury Department favors the use of only 80 percent of these indexes. An index is used to compute the base year and current year cost of each pool. To accurately determine these costs and correct the full impact of inflation, 100 percent of the CPI must be used. Anything less diminishes LIFO's usefulness to the small businessman and continues to reward those corporations that can better afford to construct their own internal

indexes using 100% of inflationary price changes.

3. allow businesses with less than $5 million in annual gross receipts to use one inventory pool and allow larger corporations to pool their goods according to broader defined categories.

My proposal would allow businesses with annual gross receipts not exceeding $5 million for the last three taxable years to use one inventory pool. Larger corporations would be permitted to pool their goods according to the general expenditure categories of consumer goods in the CPI and PPI.

4. allow taxpayers electing LIFO to use ten years (beginning with the year of LIFO election) to restore inventory writedowns to income.

Requiring the restoration of all past inventory writedowns to income by businesses which have recently converted to LIFO imposes a large initial penalty for conversion. Such a penalty contradicts the policy of providing small businesses with extra operating capital, by imposing extra tax liability on LIFO businesses. My proposal spreads the time allowed for restoration of these writedowns from three years to ten years to further reduce this initial capital drain.

5. repeal the conformity requirement.

An IRS regulation requires that businesses use the same accounting technique on their financial statements as they use in their income tax calculations. LIFO is desirable for tax calculations but not for financial statements because it increases the inventory basis, thereby reducing profit figures and tax assessments. This conformity requirement was instituted in 1940 at a time when it was

unclear whether or not LIFO would become a generally accepted accounting principle. Today LIFO is so recognized and the conformity requirement does nothing more than discourage LIFO useage.

In summary, Mr. Chairman, the LIFO simplification reforms contained in the Economic Recovery Tax Act of 1981 demonstrate the commitment of Congress and the Administration to expand the short-term financial resources of our small business community. Those reforms alone, however, will be insufficient to eliminate the major barriers to LIFO adoption. Unless the system is simplified further, corporations that can afford the battery of tax lawyers and accountants necessary to comply with these regulations will continue to enjoy substantial tax advantages over their smaller competitors. Corrective action must be taken now.

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EAST ALABAMA SERVICES FOR THE ELDERLY, Inc.

1300 COMMERCE DRIVE
AUBURN, ALABAMA 36830
TELEPHONE (205) 826-1500

August 20, 1981

Honorable Jeremiah Denton
United States Senate
110 Russell Senate Office Building
Washington, D. C. 20510

Dear Senator Denton:

I would like to submit the following testimony on behalf of the Adult Day Care Program for your hearing on August 25, 1981.

The Adult Day Care Program has significant impact on the quality of life of the elderly/handicapped persons it serves. I have seem this first hand through the intimate involvement I have had with the program over the past 5 ½ years.

Adult Day Care is a program designed to serve the needs of adults who because of physical or mental handicaps are unable to function independently. Many clients live alone and isolated with no family to care for them. Adult Day Care provides the supportive service needed to help these individuals remain in their own homes and in the community. Without this program many clients would be forced to go into institutions. The quality of life would be greatly reduced.

Many clients come into Adult Day Care depressed. confused and disoriented. Many are very limited in their ability to participate in arts, crafts and other activities. Because of the motivating nurturing nature of the program with its family atmosphere, we see some most dramatic changes. New skills are learned and a greater control over one's life and destiny occurs. We see a new interest in life develop - something to look for to - a place to go and things to do.

Over and over I have been told by visitors to our centers what a happy place it is to go! How very different it is from a nursing home.

I see Adult Day Care as one of the most promising alternatives to long term care. As a relatively new program, we who work with it recognize that there are ways in which the program needs to expand and grow. We are very enthusiastic about its potential and have seen its value to those it serves. I do hope the Aging and Human Services Subcommittee will give the Adult Day Care program very serious consideration when it is determining the effectiveness of programs.

Sincerely,

Mary Lou Blackwell

Mary Lou Blackwell
President
Alabama Association Adult Day Care

Enclosures

MLB:ed

ADULT DAY CARE - A SURVEY TO ASSESS
THE IMPACT OF ITS CLOSURE

On September 30, 1981, Adult Day Care, a program which provides supportive social services designed to prevent or delay the need for institutionalization and improve an individual's level of functioning, will cease operation. The primary funding source was Title XX administered by the Alabama Department of Pensions and Security. It removed funding for the program due to federal budget cuts. There have not been any attempts made by the State of Alabama to authorize state funding for the program. The Alabama Department of Pensions and Security (DPS) has made little effort to salvage the program.

Today, according to DPS Special Programs Division, there are thirty-four program sites serving approximately 950 people. These sites are operated under contract and vendor agreements. The Vendor Centers number thirty and they serve about 840 people. The information presented here is from the vendor sites. Twenty-three sites furnished information describing 725 people who participate in their programs.

The majority of day care participants are elderly. The age ranges of day care participants are as described in Table I.

Table I

Total	Ages	18-24	25-49	50-59	60-69	70+
725	No of People	17	71	105	183	349
100	% of total	2%	10%	15%	25%	48%

The majority of persons in day care are over 60 years of age. These individuals are on fixed incomes and financially unable to pay the cost for this service. A service which impacts on the participant and their families.

The day care programs closing would probably cause 157 people to go into a nursing home, 62 people to return to state mental hospitals, and 173 people who would be forced to quit work to care for the participants. The emotional pain and suffering would be very great. The cost to taxpayers would be great as well.

Day Care needs approximately $200 per month per person to operate including transportation. At this time, day care costs $152 per month per person including transportation. The average cost for a person's state hospitalization furnished by the State Department of Mental Health in 1980 was $1,629.12 per person. The average cost for intermediate care in a nursing home in 1980 was $825 per month. Comparison of these costs by the sample population is described in Table II.

Table II

Comparison of monthly costs between Adult Day Care and Institutions which may receive day care clients when day care closes.

No. of Persons	Facility	Total Costs per Month
725	Adult Day Care (1980)	$110,200
725	Adult Day Care (Need)	145,000
62	State Hospital	101,005
157	Nursing Home (Average - Intermediate)	133,650

With 219 people institutionalized, the cost to the government is $2,815,860 compared to a day care cost of $1,322,400. The number indicated for institutionalization is a low estimate of those people most likely to be placed in an institution. This does not consider those people placed because a caretaker is unable to continue care. So far we have looked at direct costs to closure. Another group, caretakers or person's who utilize day care so they may continue working will be affected as well. If all caretakers who worked earned minimum wage for forty hours per week, an immediate loss of income to families would be $1,224,010 (based on 173 people) per year. Whether a person is institutionalized or families cease work the taxpayers of Alabama come out loosers.

Adult Day Care helped get people out of institutions, keep people out of institutions and protected some people from abuse, neglect, or exploitation. Mental Health Centers placed 97 people in the program. Nursing Homes lost 34 people to day care. In 160 cases people were placed in Day Care rather than an institution.

People in adult day care face multiple problems. The survey did not differentiate between one single problem or multiple problems. The ranking of problems by number of people indicated is:

Nutrition	522 people
Loneliness	467 people
Transportation	456 people
Health	435 people
Depression	313 people
Confusion	281 people
Memory Loss	236 people
Family	203 people

People with health, depression, confusion, memory loss and family problems are good candidates for institutionalization of some type.

The following picture develops relative to the impact of Adult Day Care sites closing. It will probably cost the taxpayers money. The cost in institutionalization will be $1,493.460 over the current cost for Adult Day Care. This figure is fairly accurate due to the numbers of people who left institutions or avoided institutions because of the program (194) is comparable to the number of people who are thought likely to be institutionalized (219). Pressure on families with clients will increase due to the following factors: loss of income, the numbers of people abused, neglected or exploited by others, and those people in day care with family problems. A ripple effect will hit other service providers to older persons as clients are moved into systems faced with severe budget cuts. One such system is mental health services to elderly clients. Elderly Mental Health Services is usually a service which develops little fee base or contributes little income into the community mental health center. The lack of a mandated service to the elderly due to the loss of the federal Mental Health Systems Act and the reduction of the number of mandated

services under the block grant system will leave people with nowhere to go. Community Mental Health Centers will eliminate Elderly Service programs to survive fianacially. Other supportive services will disappear as the state receives 75% of their federal funding. Many service programs will disappear as this tight money must be used to pay financial services such as welfare. The impact on the elderly, minority, and poor will be dramatic. About 75% of Adult Day Care participants are over 60 by our current survey. In last year's survey, it was found that 73% of day care clients were minority members.

It has been stated that the truly needy will not suffer in our rush to cut budgets. The poor, elderly, people with physical and emotional problems, and their families are the truly needy. They make up the clientel of Adult Day Care. It would seem the planners have overlooked them. It is a sad commentary when a society abandons those who need services most. The short sightedness of the budget and program cuts look for quick cures without looking at the long range picture.

Adult Day Care was designed to reduce costs to government in the area of long term care. It has met this designed mandate in Alabama.

Phil Ives, ACSW
Chairman Adult Day Care
Research Committee

TIMES MIRROR

MARTIN P. LEVIN
Vice President
President, Book Publishing

October 7, 1981

Dear Mr. Chairman:

Times Mirror appreciates the opportunity to submit comments for the hearing record in support of S. 578.

We would like to thank Senator Moynihan for his continuous efforts in this area and to express our appreciation for the quality of the legislative solution at which he has arrived.

Times Mirror publishes medical, scientific, educational, art, and illustrated books, as well as hardcover and paperback best-sellers. Each year we publish approximately 500 new books and reprint approximately 1,500 titles. Enactment of S. 578 will make it possible for Times Mirror to continue to publish works of quality on the basis of merit, print a substantial number of copies and retain the books in inventory over an extended period of time to serve the school and popular markets.

October 7, 1981

The quantity to be printed of a book is difficult to determine at the time of initial publication and many times it is difficult to predict sales of reprints. Each book is unique, and the intellectual and educational advantages gained by individual readers can never be accurately guaged. The Thor ruling is inappropriately applied to books. It forces the publisher to destroy the book, to relegate this book to be permanently out of print in order to establish a value that would be acceptable for a tax deduction. Current IRS regulations leave publishers no other choice.

If current tax methods are retained, fewer specialized books and smaller quantities of books will be printed, and book prices will increase.

We challenge the Treasury Department's position. No tax revenues will be lost. Some modest tax payments will be deferred for a short period of time. If the slow moving book in inventory which has been depreciated to its estimated value is sold at full price, the Treasury benefits. The publisher pays his taxes on the gross profit of the book using as his cost

basis the written down value of the book. If the publisher is forced to destroy the book both the Treasury and the potential buyer are losers.

We believe the five-year inventory experience approach of S. 578 provides a fair and objective formula appropriate to the publishing industry. The experience factor would enable publishers to determine, from past experience, what inventories will not sell and those that will. In the event of sales, the inventories would be taxed accordingly.

The formula experience set out in S. 578 to calculate current deductions will yield public good and credit more revenues than destroying large quantities of books to obtain a write-off under current accounting methods.

This ruling comes at a time when this nation is struggling to regain its technical supremacy and to stimulate worker productivity. To place one more barrier on the road to our recovery would be an injustice not only to the publisher but also to the student, teacher, and the country.

October 7, 1981

For these reasons, we urge the prompt and positive committee consideration and passage of S. 578. To do less would be a denial of the value of the book and to treat our collected knowledge reflected in books as a piece of common scrap metal.

Sincerely,

Martin P. Levin
Vice President
President, Book Publishing

Association of American Publishers, Inc.

1707 L Street, N.W.
Suite 480
Washington, D.C. 20036
Telephone 202 293-2585

October 7, 1981

Before The
Subcommittee On Taxation & Debt Management

Of The
Committee On Finance
United States Senate

Hearings On S.578

September 25, 1981

Statement For The Record

ASSOCIATION OF AMERICAN PUBLISHERS, INC.

Submitted By

Mr. Townsend Hoopes, President

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The Association of American Publishers is the principal spokesman and representative of book publishers in the United States. Its 300 members include all of the major book publishers, and they account for more than 85 percent of all of the books published in the United States.

We appreciate this opportunity to submit our statement in support of Section 1 of S.578, which would amend the Internal Revenue Code to permit taxpayers to "write down" excess inventory items to their net realizable value. Internal Revenue Service rulings after the Thor Power Tool case have the effect of requiring publishers to destroy or remainder*/ books that normally would have remained available for purchase for many years. These rulings also discourage publishers from publishing slower-selling noncommercial and scholarly books, or books by little-known writers. The inventory valuation provisions of Section 1 of S.578 do much to alleviate this situation.

In the 1979 Thor Power Tool case, Thor had an inventory of replacement parts in excess of foreseeable demand, and wrote down those inventories to nearly scrap value. Although the Supreme Court recognized that the taxpayer's write-down was in accord with generally accepted accounting principles, it held that under the circumstances the IRS was within its discretion to claim that the taxpayer's method for valuing inventory "failed to reflect income clearly," because Thor had failed to provide any objective evidence whatever that the excess inventory had the market value Thor's management had ascribed to it.

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*/ To "remainder" books is to sell them in large lots at extremely low prices to remainder outlets which resell at steeply discounted retail prices.

Althougn the Supreme Court talked of IRS discretion and emphasized taxpayer's failure to provide any evidence in support of its estimate, the regulation upheld in Thor restricts the taxpayer to using only two methods of proof for determining the value of unsold inventories. Rev. Proc. 80-5 and Rev. Rul. 80-60, issued after the decision, make it clear that no taxpayer can value excess inventory lower than cost unless the goods have either been physically scrapped, or have been sold or offered for sale at the lower price.

These Thor rulings place publishers in a dilemma. Past experience tells them that it is highly unlikely that all of their inventory of a particular book remaining after the period of initial sale can be sold at the original price. Yet they are unable to take a deduction for their incurred publication expense without actually destroying the inventory or remaindering it at a price well below cost. If the publisher retains the inventory to sell, he knows that he might sell a few more copies at the original price over time. If, however, he decides to destroy or remainder the excess inventory immediately, he knows with certainty that he can pay less tax for the year in which he takes such action.

Apart from the uneconomic waste that results from confronting publishers with such a choice, the application of the Thor rulings to the publishing industry has undesirable social consequences. The changing economics of the publishing

industry have raised the cost of holding inventories, and publishers are already reluctant to print limited-circulation, noncommercial titles rather than sure-bet best sellers. Under Thor, publishers will become increasingly unwilling to sign contracts for slower-selling noncommercial and scholarly books, such as histories, textbooks, or titles by unknown authors; titles will go out of print sooner and be unavailable to researchers and students; authors not yet established will be deprived of much-needed financial support, because scrapped or remaindered books produce no royalties.

Unfortunately, the type of works that are likely to suffer the most are those to which society attaches the most cultural and academic value; the slower-selling noncommercial and scholarly books such as biographies, histories, textbooks, poetry, and "classics" which sell a few hundred copies a year for thirty years. One well-quoted example is that of Octagon Books, in New York City, which destroyed 11,000 books including copies of "Baudelaire The Critic" and "The Tennessee Yeoman: 1840-60." Such books, which are culturally important but lack mass appeal, are likely targets for destruction or remaindering under the Thor rulings.

Apart from the social consequences of applying the Thor ruling to publishing, the effects on business in general also defy economic good sense. Publishers and other taxpayers forced to scrap excess inventory in order to reduce their

tax burdens lose the potential opportunity to sell at least part of the excess at original price, and produce some profit. The public is harmed by the reduced availability of books and other publications, replacement parts, or other excess inventory items. Moreover, to the extent that the ruling encourages publishers and other producers to choose smaller printings or production orders, it may increase the price of individual items. Ironically, even the IRS is unlikely to profit from the ruling; inventory that is kept in the warehouse may eventually sell, generating taxable income, but inventory that is scrapped produces no profits -- or taxes. S.578, which permits publishers and other businesses to write down excess inventory that they reasonably expect will be disposed of at less than full realization, thus provides a course of action more profitable and economically sensible for all the parties concerned.

Concern for taxpayer abuse of write-down provisions is clearly legitimate, and, as the Supreme Court noted in Thor, taxpayers should not be allowed complete discretion in devaluing inventory to reduce taxable income. Nevertheless, the two methods of proving value permitted under the Thor ruling -- physical disposal of the inventory, or sale at the lower price -- are not the only types of evidence that taxpayers can offer to demonstrate that their inventory has, in fact, lost value. S.578 sensibly meets the problem of

taxpayer abuse by requiring the taxpayer to estimate the amount of inventory that will be disposed of at less than full realization of its cost by referring to the taxpayer's most recent five-year experience with inventories. A similar formula, known as the "Black Motor Formula," has been successfully applied by the courts and the IRS in determining allowable deductions for writing off bad debts. That precedent can be usefully applied to any disputes that might arise in valuing inventory under S.578. Thus, S.578 provides an objective, enforceable, and well-tested rule that effectively limits the taxpayer's potential for fraud and abuse.

We have, of course, carefully considered the testimony and statement of the Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, before the Committee. We submit that much of his statement, in fact, supports the enactment of Section 1 of S.578. He finds the reference to the taxpayer's own experience to be a more reasonable approach to the problem than an arbitrary reference to a uniform time period. He states that if there are situations where the regulations "impose a great hardship," the Treasury would be willing to consider relief. We respectfully submit that the testimony of William Brandner, Senior Vice President and Treasury of Harcourt Brace Jovanovich, Inc., before the Committee on September 25, 1981, and the statement of Martin E. Tash, Chairman, President and Treasurer, Plenum Publishing Corp., submitted for the record in these

hearings, provide just that evidence of hardship in the case of publishers. Since the Treasury and the IRS have thus far refused to provide administrative relief, legislation appears particularly appropriate at this time.

Finally, whatever may be the merits of the claimed revenue loss of $8 billion per year raised by Mr. Chapoton with regard to Section 2 of S.578, we do not understand that any significant amount would be involved if Section 1 were enacted, particularly if the effect were limited to industries who demonstrate hardship.

In conclusion, AAP believes that S.578 provides an effective means of overcoming undesirable economic and social effects resulting from the strict application of the Thor Power ruling, especially to the publishing industry. The bill also meets legitimate concerns about taxpayer abuse of write-downs through application of the tested Black Motor Formula to ensure that taxpayers only write down inventory to the extent that previous experience indicates a real reduction of value has occurred. S.578 is a sensible, balanced solution that meets the concerns of the Supreme Court in Thor Power while retaining the economic and social benefits that follow from publishers' write-downs of excess inventories of books.

ASSOCIATION OF AMERICAN PUBLISHERS, INC.

By:_____

Townsend Hoopes, President

nmpa National Music Publishers' Association · Inc.

110 EAST 59 STREET · NEW YORK N.Y. 10022 · (212) PLAZA 1-1930 · *Established 1917*

LEONARD FEIST *President*

The Hon. Bob Packwood, Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate
145 Russell Office Building
Washington, D.C. 20510

Re: September 25, 1981 Hearings on S. 578

Dear Senator Packwood:

The National Music Publishers' Association is the largest trade association of the music publishing business. Its membership of over 250 includes publishers of music of all genres and represents more than 75 per cent of the sales of printed music.

The Association of American Publishers has submitted a statement for the record on S. 578 to which our association fully subscribes. The consequences and impact of the Thor Power Tool decision on book and music publishing have been and will be substantially identical.

One aspect of music, however, may be more drastically and dramatically affected than any other. The publication of concert music may very well be stifled by the procedures required under Thor. Historically, there is a time lag of two or more decades between the publication of such a composition and its acceptance -- tentatively at first, and then possibly permanently. Thus, copies of concert compositions that might be destined to become part of the Western tradition of music sell hardly at all upon publication and at an agonizingly slow pace for many years. More than any other facet of music publishing, the output of concert music will be curtailed to the loss of American musical culture.

Like the Association of American publishers, and for the same reasons, the National Music Publishers' Association believes that "S. 578 is a sensible, balanced solution" to the economic dilemma created for publishing by the Thor Power Tool decision.

We would appreciate it if this letter were included in the Record.

Respectfully,

Leonard Feist

Leonard Feist

c.c.: Subcommittee Members
The Hon. Daniel P. Moynihan

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MACHINERY and ALLIED PRODUCTS INSTITUTE

1200 EIGHTEENTH STREET, N.W. WASHINGTON, D.C. 20036 202-331-8430

October 9, 1981

The Honorable Bob Packwood
Chairman
Subcommittee on Taxation and
Debt Management
Committee on Finance
The United States Senate
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman and Members
of the Subcommittee:

Inventory Write-Downs and Related Matters

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to submit its views for the public record in hearings concerning S. 578 of Senator Moynihan and S. 1276 of Senator Durenberger. Both bills deal in part with procedures for writing down excess inventories, and would change the tax law as it was interpreted by the U.S. Supreme Court in Thor Power Tool Company v. Commissioner. Additionally, the Durenberger measure would change the effective date, consent provisions, and certain exception provisions of Revenue Ruling (Rev. Rul.) 80-60 and Revenue Procedure (Rev. Proc.) 80-5.

For present purposes, we wish to address ourselves solely to that portion of S. 1276 dealing with Rev. Rul. 80-60 and Rev. Proc. 80-5. Without reference to other matters in S. 1276 on which we do not currently take a position, we believe that the proposals to amend IRS' Thor pronouncements deserve attention. It will be recalled that Rev. Rul. 80-60 and Rev. Proc. 80-5 required a taxpayer using a noncomplying accounting method for excess inventory to change its method to a permitted one on its first income tax return for its "first taxable year ending on or after December 25, 1979." Special "consent" (i.e., consent of the Internal Revenue Service' (IRS) to a change in method of accounting) and "transition" procedures (i.e., spreading the net tax adjustment from the accounting change over a number of years) were set forth, but IRS declared

MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION, COMMUNICATION AND COMMERCE) IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES

that this arrangement would not be available to a taxpayer that had used an "impermissible" method where the method had been challenged on audit and was pending as an issue as of February 8, 1980.

As indicated in our August 5, 1980 submission to this Subcommittee concerning S. 2805 in the 96th Congress and as described below in more detail, we believe that the effective dates of Rev. Rul. 80-60 and Rev. Proc. 80-5 should be changed to eliminate their partially retroactive and otherwise untimely aspects. The consent granted by Section 3.01 of Rev. Proc. 80-5 also should be redated to coordinate it with the changed effective date. Finally, we do not feel that IRS should discriminate against companies in their access to the consent, transitional, and other provisions based on the existence or nonexistence of pending audit issues. Whatever else is done with sections of S. 1276 not herein addressed, MAPI recommends that the Subcommittee give attention to these items to assure taxpayer equity in accommodating to the Thor decision. Indeed, MAPI believes that the amendments to Rev. Rul. 80-60 and Rev. Proc. 80-5 could be dealt with independently of other provisions of S. 1276, particularly the unrelated sections involving last-in-first-out inventory identification.

Our further comments and recommendations are set forth following a background note. We direct the Subcommittee's attention to the timing and sequence of events surrounding Thor because they relate directly to our contentions in favor of changes in the subsequently issued IRS pronouncements. The merit of our position should be judged in light of how taxpayers might have been expected to conduct themselves in the wake of Thor pending the issuance of instructions from IRS.

Background

As the Subcommittee is no doubt aware, Thor was decided by the U.S. Supreme Court on January 16, 1979, and the holding supported IRS' disallowance of the taxpayer's write-down of excess goods inventories to an estimate of market value that had not been substantiated by objective evidence. Basically, the Court came to the conclusion that management's judgment alone with respect to the market value of inventory--reflected, for example, by writing off some percentage of the value of slow-moving goods annually--was not enough to establish the value in question and validate the related deductions. Subsequently, on February 8, 1980, IRS issued Rev. Rul. 80-60 and Rev. Proc. 80-5 instructing taxpayers not in conformance with Thor as to what they should do to bring their accounting into compliance. Then, on April 8, 1980, IRS issued Announcement 80-54 amending Rev. Proc. 80-5 to clarify certain ambiguities and to call attention to "common errors" being encountered by IRS in taxpayers' filings of Form 3115, "Application for Change in Accounting Method."

The Timing Issue

We submit that it was inappropriate under the circumstances for IRS to require the accounting change for the "first taxable year ending on or after December 25, 1979" rather than for the "first taxable year beginning after December 31, 1979." In part, the effect of the IRS requirement has been to cause all affected calendar-year enterprises to change their inventory accounting beginning with 1979 rather than 1980. Indeed, calendar-year companies aside, we believe that all taxpayers determined by the Thor opinion to be in a nonconforming mode have been required by IRS to change accounting sooner than is justified. While we take no issue here with Thor itself, we believe that IRS has overreached in its rush to take advantage of this decision in its favor.

Harking back to the sequence of events surrounding the Supreme Court decision, Thor was decided on January 16, 1979, and it resolved a question of long standing as to the substantiation required for inventory write-downs. Being familiar with the issue, we dismiss as unpersuasive and self-serving the IRS contention that the law has been clear for 50 years. It stands to reason that costly litigation normally is not pursued to appellate levels by parties to whom the ultimate resolution is obvious or even reasonably certain. Moreover, the U.S. Supreme Court does not occupy itself with cases for which the answers are obvious or even reasonably clear to dispassionate observers. Further, it is our understanding that numerous corporate managements engaged in excess goods and percentage write-downs of the type covered in Thor without objections by tax counsel and with the belief that the activity was not questionable from a tax-accounting standpoint.

Inasmuch as the matter was put to rest on January 16, 1979, the least IRS could have done in view of the significance of that date was to have required a change of accounting for taxable years beginning after that date--which would have been more acceptable than the effective date set in Rev. Rul. 80-60 and Rev. Proc. 80-5. We contend, however, that even more time should have been allowed for taxpayers' accommodation to the decision because IRS did not publish its instructions with respect to taxpayers' changes in accounting method until more than a year later (February 8, 1980). Furthermore, in the interim period many affected taxpayers were told by competent tax professionals from outside of their own organizations--including some well-known inventory accounting experts with IRS backgrounds--to do nothing until IRS spoke to the issue.

Under the circumstances just mentioned, we are dismayed to see tax policy officials refer to taxpayers' failures to act during 1979 as questionable speculation as to whether IRS would fully implement Thor. Even more bothersome is the suggestion that some taxpayers were playing the so-called "audit lottery" for 1979 on this issue, as if a U.S. Supreme Court decision presenting them with a new and highly visible tax

exposure would be dealt with capriciously. We repeat that the advice to wait for the IRS instructions that were widely known to have been under preparation during 1979 came from reputable sources, including some persons who participated in the limited external reviews given to Rev. Rul. 80-60 and Rev. Proc. 80-5 prior to publication. Also, we understand that IRS was advised by certain of its outside consultants not to adopt the effective date that has given rise to this controversy.

From a strictly practical point of view, we also have difficulty with the idea that taxpayers could have protected their positions for 1979 by exercising precautionary measures, such as scrapping goods or offering them for sale at a lower price as compared to writing down inventory values using techniques followed in the past. With relatively few exceptions, tax accounting does not differ from financial accounting, notwithstanding certain overstated assertions to the contrary in Justice Blackmun's dictum. Inasmuch as financial accounting practice previously was identical to and dictated the course of tax reporting in many firms as it pertained to inventory write-downs, and inasmuch as the IRS instructions on implementation were not available in 1979, we think it unrealistic to contend that tax managers should have attempted to overhaul corporate-wide inventory accounting procedures while relevant questions still were unanswered.

Another government contention deserving of mention is the one to the effect that a slightly later date of application for the new requirement would sanction improper accounting and encourage tax evasion. This misses the point, and we cannot rationalize that type of reaction to such a sensible recommendation. If the Subcommittee can agree with us that fairness to taxpayers promotes compliance and can accept that the only concern here is not Thor but the unreasonably compressed timeframe set by IRS for changes to the "new" compliance mode, then the government view will quickly be seen as inapposite. We fully understand the fiscal concerns of the day, but cannot relate the changes we seek to the dire consequences foreseen either in terms of revenue loss or deteriorating taxpayer morality.

Consequently, we ask the Subcommittee to approve moving the effective date of the accounting change ahead modestly, as we have recommended, to taxable years beginning after December 31, 1979.

Audit

As previously noted, taxpayers with pending Thor-type audit issues as of February 8, 1980, were omitted from the special consent and transition arrangement. Evidently, IRS thought that it would be condoning improper accounting to do otherwise. We can understand where this would be so with a "flagrant abuse" of the tax accounting and reporting rules that is finally brought to justice, but this simply was

not true of Thor. In fact, we have no doubt that the vast majority of taxpayers who followed financial accounting standards and acted on the advice of counsel and independent accountants with regard to inventory write-downs believed themselves to be in compliance. Indeed, many never were questioned on audit because IRS auditors themselves did not uniformly consider the Thor-type practices to be incorrect. The upshot of this difference of opinion and/or experience is that taxpayers who encountered this audit issue are now treated differently from those who--fortuitously or otherwise--did not.

Frankly, we think IRS could easily have justified an approach that would have allowed companies with this audit issue to begin with a relatively clean slate, essentially on the same footing as other parties granted special consent and transition rules. IRS is not dealing here with incorrigibles, whether they have an audit issue or not. In fact, we see no reasonable basis whatsoever for assigning differing relative "values" to taxpayers that had "judgmental" excess inventory write-downs, based solely on the existence or lack thereof of a pending audit issue. Now that Thor is unquestionably the law of the land--which was not so before the decision--we believe that more could be gained by putting past disputes aside than by continuing with this grudging IRS acquiescence that has caused discrimination among affected, similarly situated parties.

Inasmuch as IRS apparently cannot bring itself to agree with this, we ask the Subcommittee to settle the question equitably by allowing "parity" for taxpayers with pending audit issues.

MAPI is grateful for this opportunity to present its thoughts to the Subcommittee on Taxation and Debt Management concerning a subject of mutual interest, and we hope that our views will be of some use in the review of S. 1276.

Respectfully,

Charles Hewett

President

TAXATION COMMITTEE

Chamber of Commerce of the United States
Washington, D.C.

October 16, 1981

TO: Senator Robert Packwood
Chairman
Subcommittee on Taxation and
Debt Management
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

RE: Hearings held on September 25, 1981 to consider legislation which would address the Thor Power problem.

The Chamber of Commerce of the United States and its over 178,000 members are pleased to have this opportunity to present their views on a matter of common concern to the members of the Subcommittee on Taxation and Debt Management and the business community at large.

The Chamber supports efforts by this Committee and others to find a substantive solution to the inventory taxation reform necessitated by the Supreme Court case of Thor Power Tool Company v. Commissioner and the Internal Revenue Service rulings which followed that case.

To summarize our position, the Chamber opposes retroactive application of the Thor Power rules to the years beginning before the Internal Revenue Service issued Revenue Ruling 80-60 and Revenue Procedure 80-5. As a result of the Supreme Court's decision in Thor Power, Revenue Ruling 80-60, and Revenue Procedure 80-5, many businesses have been required to change their method of accounting for taxable years beginning before 1980. Most of those using the FIFO (first in-first out) method of accounting must isolate their "excess" inventory which must then be sold, offered for sale, and physically scrapped, in order to sustain a write-down to realizable value. This results in added cost to the firm, which is required to segregate the excess goods and attempt to dispose of them. Additionally it may lead to the adoption of unsound business practices and inventory management techniques. Many firms were particularly hurt by the retroactive nature of Revenue Ruling 80-60 which requires a change in taxpayers' method of accounting for taxable years beginning before 1980.

While the Chamber supports the premise upon which S. 578 and S. 1276 were written, we do not favor either bill above the other. However, any legislation that would prescribe statutory rules for determining permissible write-downs to market should be broadly-based and should not discriminate between industries or companies of different sizes.

Background

The sequence of events that led to the retroactivity problem began with the case of Thor Power. In that case, Thor contended that the items in issue, which were mostly spare parts, were held in excess of any reasonably foreseeable future demand. Thus, this inventory was written down to its "net realizable value", which, in most cases, was scrap value. Despite this writedown, Thor continued to hold these goods for sale at their original prices, as due to the peculiar nature of these articles, price reductions would not aid in moving this "excess" inventory. The taxpayer did not choose to sell these items at scrap value because of its hope that demand for these parts might ultimately prove greater than anticipated.

In January of 1979, the Supreme Court held that Thor's procedures for writing-down the value of its "excess" inventory were inconsistent with the Treasury Regulations promulgated under Section 471. Since Thor neither sold this inventory nor offered it for sale at prices below replacement cost, it could not take advantage of the opportunity for lower valuation of inventory offered by Section 1.471-4(b). Furthermore, the taxpayer failed to provide any objective evidence that the inventory had the market value ascribed to it as required by the Regulations. The Court found that Thor had not realized any present loss and, therefore, could not write down the inventory until such time as it was willing to scrap these "excess" parts.

The decision did not require all taxpayers using the method found incorrect in Thor Power to switch to another method. Many CPA's, tax attorneys, and other tax consultants advised their clients that they could not change their accounting methods without prior approval of the IRS. Many tax advisors also questioned whether the court's decision would be applied to other industries. The IRS did not provide guidance on what taxpayers should do until February 8, 1980.

On that date, the IRS issued Revenue Ruling 80-60 and Revenue Procedure 80-5. These rulings gave all taxpayers using the valuation method found wrong in Thor Power (the "prescribed method") approval to change accounting methods. The rulings required taxpayers to make the changes beginnining in their first taxable year ending on or after December 25, 1979. The effect of these rulings was to require taxpayers using the "proscribed method" to restore to income the difference between the scrap value and the cost of the excess inventory still in stock.

Procedures were set out allowing many taxpayers to spread over a number of years the amount that had to be restored to income.

The Problem

Thor Power was decided on January 16, 1979 and struck down procedures that had been standard practice for many taxpayers and tax practitioners, sometimes adopted with approval of IRS auditors. Estimating and substantiating market value under the lower of cost or market rules did not involve an actual sale. The prescribed departures from traditional practices caused new tax liability exposures, and as a result, many tax advisors counseled clients to do nothing until the IRS issued official and publically available information. It appeared to be common knowledge among tax advisors at that time that a revenue procedure and revenue ruling to implement Thor Power were being developed at the IRS.

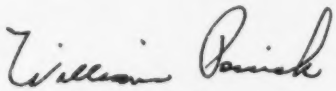
Many firms had begun their accounting period just before Thor Power was decided and it was several weeks before its contents and implications were known to tax professionals. Many businesses didn't become aware of the case or its effect of their own business until the IRS made its announcements more than a year later.

Revenue Procedure 80-5 and Revenue Ruling 80-60 were issued on February 8, 1980 and both documents were published in the Internal Revenue Bulletin over a month later on March 10, 1980. Even this information was not enough, because the Service then issued Announcement 80-54 to clarify ambiguities in Revenue Procedure 80-5. The amended Procedure 80-5 was finally issued on April 8, 1980, and published in the Internal Revenue Bulletin on April 28, 1980, more than 15 months after the Thor Power decision.

Relief is needed from the burden imposed by the retroactive application of the Thor Power rules. S 578 introduced by Senator Moynihan and S 1276 introduced by Senator Durenberger look to formula or experience write-downs to solve the Thor Power dilemma. This is a laudable goal, but we recognize the inherent compliance and equity problems associated with such an approach.

We strongly urge the Subcommittee to continue to search for a substantive solution which will be broadly-based, that is, which will not discriminate between firms of different size or industry We firmly believe that the solution should offer relief to the entire business community affected by the Thor Power decision.

On behalf of the U.S. Chamber, I want to thank you for your consideration.



Mr. William Penick
Chairman, Inventory Reform Task Force
of the Taxation Committee

NJEDA
New Jersey Economic
Development Authority

John J. Horn
Chairman

James J. Hughes, Jr.
Executive Director

WRITTEN TESTIMONY BY

JAMES J. HUGHES, JR.
EXECUTIVE DIRECTOR

NEW JERSEY ECONOMIC DEVELOPMENT AUTHORITY
TRENTON, NEW JERSEY

TO THE

U.S. SENATE
FINANCE COMMITTEE

CONCERNING

TAX EXEMPT SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS AND SPECIFICALLY BILLS S-768 AND S-1472

OCTOBER 9, 1981

Capital Place One - CN 990, 200 South Warren Street, Trenton, New Jersey 08625 • Telephone (609) 292-1800

TESTIMONY CONCERNING S-768 AND S-1472

NEW JERSEY ECONOMIC DEVELOPMENT AUTHORITY

TO THE

U.S. SENATE COMMITTEE ON FINANCE

OCTOBER 9, 1981

I appreciate very much the opportunity to present the views of the New Jersey Economic Development Authority regarding S-768 and S-1472. These bills would retain the tax exemption for industrial development Bonds (IDBs) used for research and development, but would treat research and development as a business expense and not as a capital expenditure. As such, it would not be included in the $10 million limit otherwise applied to projects financed by IDBs.

We Support S-768 and S-1472.

I - The Tax Exemption for IDBs Must Continue

The IDB is an effective and uniquely efficient capital investment tool. The economic and employment benefits to the nation from this instrument have been enormous. In New Jersey alone, IDBs have stimulated over $2.5 billion in investments since 1975, and added over 66,000 new jobs and 35,000 construction jobs. On a best case basis the New Jersey Economic Development Authority has calculated a $7.8 billion revenue flow back from IDB issues in the nation for fiscal year 1981. Thus, any revenue loss attributed to IDB tax exemption has been more than offset by gains in local, state and federal tax revenue.

It is our position that the federal establishment, both the Congress and the Executive Branch, should regard the industrial development bond program as a matter for states' responsibility rather than for federal regulation. We believe such a program can be operated nationally according to the following provisions:

1. Retention of the tax exemption for industrial development bonds.
2. State responsibility for directing the use of IDBs according to national guidelines.
3. National reporting.
4. Public meeting prior to approval of bond issuance.

II - Importance of IDB Financing of Research and Development

Since 1975, the New Jersey Economic Development Authority has provided financing to 36 research and development projects amounting to $65.8 million in IDBs and $72.8 million in total investment. These projects are associated with 1,900 jobs plus the construction employment.

These projects, for example, constitute research and development for:

- hazardous waste disposal
- fuel from coal
- scientific instruments
- special purpose cathode ray tubes
- injection lasers
- dental optics
- artificial kidney components.

Research and development is crucial to technological growth. Improved productivity depends upon it. A significant amount of research and development is financed directly by the federal government through Defense, NASA, Energy, the National Science Foundation, and many other agencies. The IDB method enables the private sector to provide its own financing through the bond market.

We wholeheartedly agree with Senator Jeremiah Denton in his July 14, 1981 statement on this matter that if a firm spends a large share of its budget on research and development, it then cannot afford to finance its capital facilities through an industrial development bond. And, as Senator Denton stated, the current rule adds to the bureaucratic burden on business because of the consequent need for detailed expenditure segregation and analysis, creating business and investment uncertainty in the process.

These observations are cogent and persuasive in themselves.

However, there is still another significant reason for removing research and development expenditures from the IDB capital spending limit. That reason goes to the critical point in the investment decision, namely, the cost of borrowing. This distinguishes the IDB incentive from accelerated depreciation incentives and tax credits.

For small and medium high technology firms the inclusion of research and development costs as capital items obstructs their use of IDB financing for the essential next step, namely, production for market.

It is in contemplation of this next step that research and development is undertaken in the first place. Without initial production the potential research and development contribution to the American economy is wasted. Furthermore, it is precisely at that next step, manufacturing, where it is in the national interest to provide the investment incentive.

Small and medium technology businesses often do not have access to capital through the sale of stock. Such businesses are restricted in the use of retained earnings due to low profitability connected with start-up costs. They obtain capital mainly from commercial lending institutions. They must compete with larger and older corporations considered to be good customers of the institution. Often small companies are offered commercial credit only at rates up to four percentage points above prime.

These difficulties of financing capability, coupled with the advantages of large corporations in financing and marketing products, creates a permanent inhibition against small and medium firms' research and development endeavors. This inhibition must be mitigated in some degree. The proposed IDB research and development exemption will successfully contribute to such mitigation.

WASHINGTON OFFICE

AMERICAN LIBRARY ASSOCIATION

BOX 54 • 110 MARYLAND AVENUE, N.E. • WASHINGTON, D. C. 20002 • (202) 547-4440

October 8, 1981

The Honorable Bob Packwood, Chairman
Subcommittee on Taxation and Debt Management
Senate Committee on Finance
U.S. Senate
Washington, D.C. 20510

Dear Senator Packwood:

The American Library Association (ALA), a nonprofit educational organization of over 38,000 librarians, library trustees and citizens, supports the enactment of legislation which would alleviate the financial effect on publishers of Internal Revenue Service rulings resulting from the U.S. Supreme Court decision in Thor Power Tool Co. vs. Commissioner of Internal Revenue. This statement is submitted to the Subcommittee for the hearing record on S. 578 and S. 1276.

Reflecting the concern of its membership about the long term effects of the Thor decision on the availability of books for libraries and their users, ALA's Council passed a resolution (attached) in February 1981, urging Congress to take legislative action. ALA believes that a permanent special tax treatment for publishers' inventories is needed and is justified for two reasons. First, books are different from power tools. There is no evidence that specialized books sell more quickly if prices are reduced as is recommended for tools in the Thor case. Second, the availability of information to enable the free flow of ideas in the marketplace is the very cornerstone of this country's constitutional foundation. This cornerstone must not be jeopardized because of the real world impact of a technical tax ruling.

The changes in inventory accounting required by the Thor decision and its implementing IRS regulations will cause a grave problem for the nation's libraries because libraries depend heavily on publishers' backlist inventories. For example, in fiscal year 1979, the San Francisco Public Library bought 79,588 volumes, about 40 percent of which were from backlists. The percentage for children's books was even higher. At the University of South Dakota, of the 1,587 books purchased between July 1980 and July 1981, 43 percent were more than two years old, and at least 25 percent were obtained from publishers' backlists. Books now go "out-of-print" too quickly and are, therefore, no longer available through regular channels. ALA is convinced that the Thor decision will increase the severity of this situation by forcing publishers to destroy backlist titles in exchange for an economic incentive they cannot afford to refuse.

In the areas of information and scholarship in which libraries and publishers are primarily interested, the impact of Thor is especially devastating. In the short run, some smaller publishers will have to burn or shred their books in order to be afforded the 1980 and 1981 tax deductions they need just to stay in business.

Some publishers may be put out of business because of the denial after-the-fact of the 1979 deduction about which nothing (shredding books or otherwise) can be done. Only the most successful publishing houses will be able to absorb the unanticipated costs and maintain their inventories intact.

In the long run, good business tactics will require that publishers only publish those books likely to sell quickly and forego slower sellers. Scholarly and scientific materials and children's literature will be even harder to locate. And those smaller publishers which until now have been the ones willing to take risks with such materials are likely to fail because their working capital will be tied up in inventory which, though it is important, does not produce profits quickly enough. The works would sell eventually, but the publishers will not be able to wait.

New ideas will not be able to enter the marketplace as easily as they did before Thor. The nation's solution-seekers will be denied the specialized information they need to support their work. Libraries which previously have purchased holdings from publishers' backlists will lose the opportunity to add important titles to their collections. Backlists will evaporate, and the nation's storehouse of knowledge will be further depleted.

When a new course is added to the curriculum in an academic institution, its library acquires books and other materials required. Many of the books needed are recently published and easily available, but others, the classics of their respective subject fields, will be older, available only if a publisher has maintained them in inventory. The problem is compounded for new libraries building a collection in a growing metropolitan area, in an expanding suburb, in a new community college or an expanding corporation. Whatever the type, age or size of library, however, every library's book and related materials budget has already been drastically cut by the impact of inflation and competing demands. Reduced support and eratic funding, particularly in states like California and Massachusetts with their taxpayers' revolts, mean that many libraries must postpone purchasing books until funds are available. If the books required to strengthen a library collection or to fill in the gaps are not available because publishers cannot afford to maintain their inventory of slower selling scholarly, scientific, technical and juvenile works, the American people, who depend on libraries as a prime source of knowledge and information, will be the loser.

We have addressed these implications as they affect libraries because we think that the Thor decision and the implementing IRS rulings have a detrimental effect on all types of libraries throughout the country and their capacity to serve the changing, daily needs of their various users. The ALA appreciates the interest which the Subcommittee has shown in this issue and urges you to act promptly to pass legislation which will reduce the negative impact which the IRS rulings have had on the publishing industry. Our support for such legislation reflects ALA's commitment to the highest quality of library and information services for the people of the United States.

Sincerely,

Eileen D. Cooke

Eileen D. Cooke
Director
ALA Washington Office

EDC:ps
Attachment
cc: Senate Finance Committee

THOR RESOLUTION

WHEREAS, the Supreme Court's decision in Thor Power Tool Co. v. Commissioner (439 U.S. 522 (1979)) has the effect of forcing publishers either to maintain backlist inventories at full initial value or to cause unconscionable waste by destroying the books so that they can deduct a tax loss and untie assets to invest in new titles; and

WHEREAS, the Thor decision will, in the long term, have an impact upon the business environment such that publishers will tend to publish only those titles likely to sell very quickly, before the end of the taxable year, and forego publishing titles likely to sell more slowly; and

WHEREAS, many worthwhile titles and vital resources are nonetheless relatively slow-selling works and are therefore apt to be very hard to acquire or even unavailable after the full impact of the Thor decision is felt; and

WHEREAS, libraries order large parts of their collections from backlists especially during times of budget reductions when they are forced to maintain periodical subscriptions and postpone the purchase of worthy book titles until the following year; and

WHEREAS, the free flow of ideas in the marketplace is the very cornerstone of our country's constitutional foundation; intellectual exchange between solution-seekers is made possible by specialized literature and is the foundation of advancement in every area; and the value of making classical, educational, scientific, and children's literature available to America's citizens is impossible to measure in strictly economic terms;

NOW THEREFORE BE IT RESOLVED that the American Library Association express its grave concern over the impact of the Thor decision on the dissemination of knowledge throughout society and urges Congress to take action to alleviate this negative impact.

Adopted by the Council of the
American Library Association
Washington, D.C., February 4, 1981

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SENATOR BOB PACKWOOD RPT DLY MGM
CAPITOL ONE DC

THE MUSIC PUBLISHERS ASSOCIATION OF THE UNITED STATES ENDORSES THE STATEMENT SUBMITTED BY THE ASSOCIATION OF AMERICAN PUBLISHERS RELATIVE TO S.578 ON WHICH YOUR COMMITTEE HAS RECENTLY HELD HEARINGS. OUR ASSOCIATION IS CLOSELY RELATED TO THE NATIONAL MUSIC PUBLISHERS ASSOCIATION AND WE ALSO WISH TO ASSOCIATE OURSELVES WITH THAT ORGANIZATION'S LETTER OF OCTOBER 9TH, 1981. RESPECTFULLY,
ARNOLD BROIDO, PRESIDENT MUSIC PUBLISHERS ASSN
PRESSER PL
BYRN MAWR PA 19010

09159 EST

IPMPDMX WSH

1902 Association Drive, **Music Educators National Conference** Reston, Virginia 22091

MUSIC EDUCATORS NATIONAL CONFERENCE

RESOLUTION

The Music Educators National Conference views with deep concern the immediate and long-range consequences of the Internal Revenue Service rulings which result from the Supreme Court decision in the Thor Power Tool Company case. Although that case related to tax treatment of inventory write-downs on parts for hand power tools, it nevertheless has had unexpected and will have serious consequences for music education.

Under the Thor ruling, publishers can no longer write down the inventory values of unsold publications held in their warehouses while continuing to sell them at regular prices. Slow-selling music publications, scores, and books have to be destroyed; sold out at whatever price they might bring; or, in the alternative, publishers could be faced with disastrous tax consequences.

We emphasize that often those publications which may have the greatest influence on the development of education or on the art of music may be those which, after their initial publications, will sell very slowly for many years. Their withdrawal from the market, however, would seriously impede the traditional, historic progress of the art of music.

Music Educators National Conference urges Congress to avert the devastating effects of the Thor Power Tool decision upon composers and authors and on the traditional inventory system which has kept music publications of lasting educational, cultural, and aesthetic value in print and, thus, available to schools, performers, libraries and scholars to the benefit of our society.

NATIONAL EXECUTIVE BOARD
Music Educators National Conference
April 1981

INGAA

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122 South Michigan Avenue
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October 9, 1981

The Honorable Robert Packwood, Chairman
Subcommittee on Taxation and
Debt Management
Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

The Interstate Natural Gas Association of America (INGAA) is a non-profit national trade association whose membership consists of virtually all of the major interstate natural gas transmission companies in the United States. INGAA's members transport approximately 90% of the natural gas that is sold in interstate commerce. All of its members are subject to regulation by the Federal Energy Regulatory Commission (FERC).

Most of INGAA's member companies maintain inventories of natural gas in underground storage pools, mainly for service to high priority, temperature sensitive customers during winter months. A majority of the companies maintaining such inventories account for them using the Last In - First Out (LIFO) method of inventory accounting.

INGAA is concerned about S.578, a bill to amend the Internal Revenue Code to change certain accounting rules relative to inventory. This bill would (among other things) revoke the LIFO conformity requirement. For the reasons discussed below INGAA believes the LIFO conformity requirement should continue to apply to the inventories of regulated companies where the sale of such inventories is subject to the jurisdiction of a regulatory body.

If the LIFO conformity requirement is removed from the Code, INGAA anticipates that the FERC may order companies under its jurisdiction to use some method other than LIFO to account for their gas storage inventories for ratemaking purposes. Indeed, over the past two years the FERC staff has attempted to force some companies to change from the LIFO method of inventory accounting to a different method. The staff proposals were rejected on the basis of evidence to the effect that implementing the staff proposals would place companies with inventories of natural gas in underground storage in violation of the LIFO conformity requirement.

There is no question that switching an INGAA member company from LIFO to another method of inventory accounting will cause an immediate increase in the company's income for tax purposes and a corresponding reduction in its regulated cost of service for rate purposes. In the short run, rates to consumers would likely be reduced. INGAA is convinced that any cost of service and rate reductions resulting from a change from LIFO to another method will be transitory at best and will ultimately work to the detriment of the consumer.

The precise impact of being forced off of LIFO will vary from company to company depending upon the facts. For a pipeline company that has been using the LIFO method of accounting for storage inventories for 15 to 20 years, (as have several INGAA member companies) a substantial portion of its gas in inventory was acquired at very low costs when compared to today's prices. For a pipeline company with a relatively large storage inventory as compared to sales, changing from LIFO to a First In - First Out (FIFO) or an averaging method of inventory accounting could decrease the company's cost of service in the first year. However, this decrease will diminish rapidly as the older, cheaper gas is sold and more expensive current purchases are placed in storage, and therefore in the rate base upon which the consumer will pay a rate of return and associated income taxes. By the sixth or seventh year, the cost of service and therefore rates will begin to increase over what they would have been had the company stayed on LIFO.

One INGAA member company with a large storage inventory estimates that its rate base for the same quantity of storage inventory will increase from approximately $100 million to approximately $1.3 billion in a 12 year period if it is forced off of LIFO. For the consumer to have to pay return and related income tax on an unnecessary investment such as this would place an expensive and avoidable burden on him.

INGAA is convinced that the best interests of its companies and their consumers would be served if the LIFO conformity requirement remained in the Code with respect to those companies. Consequently INGAA respectfully submits (attached hereto) for your consideration a proposed amendment to S.578 which would retain the LIFO conformity rule in the Code only with respect to public utility companies selling inventories subject to the jurisdiction of a regulatory agency. In deference to those regulated companies which also sell inventory outside of the regulatory jurisdiction, the scope of the amendment is limited only to that inventory which comes within the jurisdictional purview of the regulatory agency.

Your favorable consideration of the proposed amendment will, over a period of time, serve to alleviate the added cost burden on consumers which will otherwise occur. We appreciate the opportunity to submit this statement and would be pleased to respond to any questions or requests for data you or your committee may have.

Respectfully submitted,

Jerome J. McGrath, President
Interstate Natural Gas Association of America

Attachment

cc: Honorable Patrick Moynihan
Harry Graham

PROPOSED AMENDMENT TO S.578

Section 472 of the Code (relating to last-in, first-out inventories) is amended by striking out subsections (c) and (e), by redesignating subsection (d) as subsection (c), and by adding new subsection (d) as follows:

(d) SPECIAL RULE FOR PUBLIC UTILITIES -- A taxpayer who has "public utility property" within the meaning of section 167(l)(3) may use the method described in subsection (b) in inventorying goods, the sale of which is subject to the jurisdiction of any agency or instrumentality of the United States or a public service or public utility commission or other similar body of any State or political subdivision thereof, only if the taxpayer uses the procedures specified in subparagraph (b)(1) and (b)(3) in inventorying such goods to ascertain the income, profit or loss of the taxpayer for the purpose of a report or statement covering such taxable year to shareholders, partners, or other proprietors or beneficiaries, or for credit purposes and for purposes of computing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account.

87-056 O—91——15

nAWGa

Statement on

Inventory Reform

by

Denis R. Zegar
Director, Government Services
National-American Wholesale Grocers' Association

Before the

Committee on Finance
Subcommittee on Taxation and Debt Management
United States Senate

September 25, 1981

National-American Wholesale Grocers' Association
1511 K Street, N.W., Washington, DC 20005 – phone 202/783-6060
(Association Headquarters: New York, NY – phone 212/532-8899)

nAWGa

Summary Statement

Denis R. Zegar, Director Government Services

National-American Wholesale Grocers' Association

Senate Finance Committee

September 25, 1981

Mr. Chairman, on behalf of NAWGA's nearly 400 wholesale grocers whose annual sales volume approaches $50 billion, accounting for roughly one-third of the Nation's grocery supply distributed through nearly 800 distribution centers nationwide, I would like to commend the efforts of this Committee in addressing the serious problem of inventory reform.

I appreciate the opportunity today to address an often misunderstood and neglected area of tax reform--LIFO simplification. The "Thor problem" needs to be resolved in a manner that is clear and consistent with the recent Supreme Court decision. However, to address Thor alone without dealing with the broader and more fundamental problems of inventory reform, will only perpetuate the same sort of piece-meal approach that has led to the burdensome and confusing inventory accounting systems we have today.

The most efficient and effective method of resolving the Thor problem is to encourage more companies to switch to the LIFO inventory method of accounting. Companies that have changed their inventory accounting method to LIFO do not have a Thor problem since under LIFO, all inventories must be valued at cost thus eliminating the need to supply evidence to the Internal Revenue Service of market value. Unfortunately, the Economic Recovery Act of 1981 did little to encourage companies to switch to LIFO accounting particularly in the wholesale grocery industry.

I urge this Committee and your counterparts in the House to consider the following inventory changes:

1. Increase the gross receipts requirement for single pooling from $2 million to $10 million. A grocery wholesaler with gross sales of less than $2 million couldn't operate his business over any extended period of time.

2. Increase the penalty period for converting to LIFO from 3 years to 10 years. This would accomplish two goals: (1) eliminate the "Thor problem" by facilitating the conversion from FIFO to LIFO and, (2) help mitigate the high cost of borrowing to pay the penalty.

National-American Wholesale Grocers' Association
1511 K Street, N.W., Washington, DC 20005 – phone 202/783-6050
(Association Headquarters: New York, NY – phone 212/632-8899)

3. Require Treasury to allow LIFO taxpayers to use regularly published government price indexes, such as 100% CPI or PPI measures. In addition, the taxpayer should be allowed the option to use the "Chain Link" method of simplification if he chooses to use his own constructed index.

4. Require Treasury to promulgate a de minimis rule allowing taxpayers to use the next broadest inventory category for commodity lines that represent less than 10% of total inventories.

5. Require Treasury to specify an audit proof number of maximum inventory pools a taxpayer can use whether it be the 11 CPI or 15 PPI categories or some other category class. The regulation should also allow the taxpayers the flexibility to use more pools than specified if greated detail is desired.

Mr. Chairman, Members of the Committee, I appreciate the opportunity to present to you the views of the National-American Wholesale Grocers' Association (NAWGA) on Inventory Reform now under review by your Committee.

NAWGA is a non-profit trade association of grocery distribution companies that provide programs in technical, educational, and government services on behalf of its nearly 400 wholesale grocers. NAWGA members operate over 850 distribution centers nationwide, serving independent grocery stores and foodservice establishments throughout the Nation. NAWGA members' annual sales volume approaches $50 billion, accounting for roughly one-third of the Nation's grocery supply distributed through such centers. In addition, NAWGA members employ approximately 250,000 people nationwide.

I appreciate the opportunity today to address an often misunderstood and neglected area of tax reform-- LIFO simplification. The "Thor problem" needs to be resolved in a manner that is clear and consistent with the recent Supreme Court decision. However, to address Thor alone without dealing with the broader and more fundamental problems of inventory reform, will only perpetuate the same sort of piece meal approach that has led to the burdensome and confusing inventory accounting systems we have today.

The most efficient and effective method of resolving the Thor problem is to encourage more companies to switch to the LIFO inventory method of accounting. Companies that have changed their inventory accounting method to LIFO do not have a Thor problem since under LIFO, all inventories must be valued at cost thus eliminating the need to supply evidence to the Internal Revenue Service of market value. Unfortunately, the Economic Recovery

Act of 1981 did little to encourage companies to switch to LIFO accounting, particularly in the wholesale grocery industry.

It is both disturbing and confusing to me that Congress has placed such great emphasis on providing massive tax relief for capital intensive industries while, at the same time, virtually ignoring inventory and labor intensive companies. The wholesale grocery industry's two most important assets are its employees and inventory (which may account for nearly 40% of its total investment). If the Committee would indulge me several minutes, I would like to provide a scenerio that has become the norm rather than the exception.

The wholesale distributor operates in much the same way as the human brain. The wholesaler is the center of all economic activity just as the brain is the center of all human functions. As the brain receives and processes these impulses and routes them to some other part of the body, the wholesale grocer receives merchandise from the manufacturer, stores and processes the orders, and then directs the goods to customers all over the nation. If the brain ceases to function properly, the movements of the body may be impaired. If the wholesaler-distributor network ceases to function properly, chaos in the market place is inevitable. Without the wholesaler, there would be no viable mechanism to provide the goods and services the American consumer has come to expect and rely upon.

At the same time, our members are in a very vulnerable position as they are being squeezed from two directions. First, when we are in a restrictive economy fueled by spiraling interest rates and high inflation, our customer, the retailer, has great difficulty meeting creditor obligations. They are late in

paying the manufacturer. Since the distributor can't absorb the cost of financing his inventory, he must renegotiate the terms previously granted even his best customers. Wholesale grocers, who operate on a ratio of net-profits-to-net-sales of less than one percent also must reduce their inventories in order to raise capital to cover the "float" of lagging receivables. And so the wheel turns. The bottom line of this scenerio is that the consumer must pay higher and higher costs at the supermarket. This only worsens inflation. A recent survey of our members illustrated the following concerns:

1. All our members are reducing their inventories on hand by as much as 10 percent. Reducing inventories is one way to raise capital and not have to go to capital markets.

2. Many of our members must lay off employees. Since our industry is labor intensive, this is the only way to raise badly needed capital.

3. Because of the extreme cost of money, our members are no longer able to take advantage of the "good deal" from suppliers which, typically, is passed on to the consumer in the way of lower costs. The net effect is even higher costs to the consumer which keeps pushing inflation higher and higher.

4. There is a greater need to reduce "net terms", increase mark-up costs and charge certain "fees" to the retailer to partially absorb increasing overhead. This, too, is inflationary.

To put this in more concrete terms, let me give you an example of two of our more typical NAWGA members.

	Company A	Company B
Gross sales	$75 million	$820 million
Avg. Monthly Inventory	$8.3 million	$60 million
Total Employment	280	1600
% reduction of inventory	15	10
% reduction of employees	10	5-10 next 6 months

As is typically the case, the smaller the firm the more severe the cutbacks.

In addition to these more obvious consequences, any future plant and equip-

ment expansion will be postponed indefinitely due to rapidly increasing costs of doing business.

If this vital sector of our economy is to survive, that is, continue to supply and service the hundreds of thousands of supermarkets, food outlets, schools, churches, and restaurants as well as the 220 million people who consume these products, Congress and the Administration must recognize the problems that face inventory and labor intensive industries.

This Committee is to be commended for your efforts in confronting some of these problems. In addition to the Thor problem, Congress must do more in the area of inventory reform than the minor changes in the LIFO provisions of the Economic Recovery Act of 1981. I urge the members of this Committee, as well as your counterparts in the House, to hold hearings on broader inventory reforms. This would allow industry representatives to be more specific as to which provisions are in need of change so that the major sectors of our economy can work in concert and get America back on its feet. I have taken the liberty of suggesting several needed changes in the area of inventory reform:

1. Increase the gross receipts requirement for single poolings from $2 million to $10 million. A grocery wholesaler with gross sales of less than $2 million couldn't operate his business over any extended period of time.

2. Increase the penalty period for converting to LIFO from 3 years to 10 years. This would accomplish two goals: (1) eliminate the "Thor problem" by facilitating the conversion from FIFO to LIFO and, (2) help mitigate the high cost of borrowing to pay the penalty.

3. Require Treasury to allow LIFO taxpayers to use regularly published government price indexes, such as 100% CPI or PPI measures. In addition, the taxpayer should be allowed the option to use the "Chain Link" method of simplification if he chooses to use his own constructed index.

4. Require Treasury to promulgate a de minimis rule allowing taxpayers to use the next broadest inventory category for commodity lines that represent less than 10% of total inventories.

5. Require Treasury to specify an audit proof number of maximum inventory pools a taxpayer can use whether it be the 11 CPI or 15 PPI categories or some other category class. The regulation should also allow the taxpayers the flexibility to use more pools than specified if greated detail is desired.

I wish to conclude my testimony by congratulating the Chairman and the members of the subcommittee for holding this hearing. I hope that the suggestions and recommendations heard today will prompt serious consideration to the needs of our industry as well as other inventory intensive industries. Thank you for the opportunity to appear before you today.

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